2020 Interim Financial Report

Providing our customers with financial security for retirement

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Challenger Limited ACN 106 842 371

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Contents

Key dates

24 March 2020
Interim dividend payment date

11 August 2020
Full year financial results

23 September 2020
Final dividend payment date

29 October 2020
2020 Annual General Meeting

Full listing of key dates available at

› challenger.com.au/shareholder/shareholder-information/key-dates

Dates may be subject to change

About this Interim Financial Report

The 2020 Interim Financial Report can be downloaded from Challenger's online Shareholder Centre at:

› challenger.com.au/shareholder

Operating and financial review

1 About Challenger

Challenger Limited (Challenger, CGF, the Group or the Company) is an investment manager founded in 1985. Challenger is the largest annuity provider and one of the largest[1] active fund managers in Australia. It is also expanding into international markets.

Challenger is listed on the Australian Securities Exchange (ASX) and has offices in Australia, London and Tokyo. Challenger is regulated by the Australian Prudential Regulation Authority (APRA), the Australian banking, superannuation, general insurance and life insurance regulator.

Challenger's activities are also subject to supervision by other regulatory agencies both in Australia and in other markets in which it operates.

Challenger's assets under management were $86.4 billion, up 10.2% on the prior corresponding period (pcp). Normalised net profit before tax was $278.6 million, up $8.6 million or 3.2% on the pcp. See sections 2 and 7 for a description of Challenger's operating segments and its normalised cash operating earnings framework.

Normalised net profit after tax was down $8.4 million or 4.2% to $191.4 million. Total Comprehensive Income after tax for the period, which includes investment experience (i.e. the valuation movements on assets and liabilities supporting the Life business) and non-recurring significant items was $220.4 million. This was mainly due to positive investment experience. Challenger had total equity of $3.7 billion as at 31 December 2019 and employed 717 people on a full-time equivalent (FTE) basis.

2 Operating segments and principal activities

For internal reporting and risk management purposes, Challenger's principal activities are divided into two operating segments: Life and Funds Management. The Life operating segment is serviced by the Distribution, Product and Marketing team, which is responsible for ensuring the appropriate marketing and distribution of Life's products. Both operating segments and the Distribution, Product and Marketing team are supported by centralised operations which are responsible for appropriate processes and systems, in addition to providing the necessary resources to meet regulatory, compliance, financial reporting, legal and risk management requirements.

Life – the Life segment mainly comprises Challenger Life Company Limited (CLC), Australia's leading provider of annuities and guaranteed retirement income products.

Life's annuity products appeal to retirees because they provide security and certainty of guaranteed income while protecting against risks from market downturns and inflation. Lifetime annuities protect retirees from the risk of outliving their savings by paying guaranteed income for life.

The retirement incomes Life pays are backed by a high-quality investment portfolio, predominantly in fixed income and commercial property investments. These long-term investments generate regular and predictable investment income which is used to fund retirement incomes paid to Life's customers.

Life's products are distributed via independent financial advisers and financial advisers tied to the administrative platforms serviced by the four major Australian banks and AMP (the 'major hubs'). Life's products are included on all major hub Approved Product Lists (APLs) and are available on other leading investment and administration platforms.

Life is the market leader in Australian retirement incomes, with a 76%[2] annuity market share and has won the Association of Financial Advisers 'Annuity Provider of the Year' for twelve consecutive years.

Life also has an annuity relationship with Mitsui Sumitomo Primary Life Insurance Company Limited (MS Primary), a leading provider of both US dollar and Australian dollar denominated annuities in Japan.

Funds Management – the Funds Management segment focuses predominantly on the retirement savings phase of Australia's superannuation system by providing products seeking to deliver superior investment returns. Funds Management is also expanding into international markets.

As one of Australia's largest[1] active fund managers, Funds Management invests across a broad range of asset classes including fixed income, commercial property and Australian and global equities. The Funds Management segment comprises two business divisions: Fidante Partners and Challenger Investment Partners (CIP).

Fidante Partners encompasses a number of investments in boutique investment managers that each operate under their own brands. Fidante Partners provides administration and distribution services to the boutique investment managers and shares in the profits of these businesses through equity ownership. Fidante Partners also has a presence in Europe with interests in alternative asset managers.

[1] Consolidated FUM for Australian Fund Managers – Rainmaker Roundup, March 2019.

[2] Plan for Life – September 2019 – based on annuities under administration at 30 September 2019.

2 Operating segments and principal activities (continued)

CIP develops and manages assets for CLC and under Challenger's brand on behalf of third-party institutional investors. The investments managed by CIP are predominantly in fixed income and commercial property.

The Funds Management business is growing strongly, with funds under management (FUM) increasing by more than 50% over the last five years to $83 billion.

Principal activities – there have been no significant changes in the nature of these principal activities or the state of affairs of the Company during the period.

3 Challenger's vision and strategy

Challenger's vision is to provide its customers with financial security for retirement. Challenger has four strategic pillars to ensure that it achieves its vision over the long-term. The four strategic pillars are:

- increase the use of secure retirement income streams;
- lead the retirement incomes market and be recognised as the partner of choice;
- provide customers with excellent funds management solutions; and
- maintain leading operational and people practices.

4 Risk management

An integral part of risk management for Challenger is the maintenance of a strong risk culture amongst its employees. Challenger's expectations of its employees are encapsulated in the 'Challenger Values' of Act with integrity, Aim high, Collaborate and Think customer. Employees are made aware that these values should form the basis of all behaviours and actions.

The management of risk is fundamental to Challenger's business and to building shareholder value and has been the key to Challenger's profitable and disciplined growth over many years. At Challenger, risk is everyone's business. The Board's Risk Appetite Statement outlines the level of risk that is acceptable in striving to achieve Challenger's strategic goals and financial objectives. This is combined with a robust risk management framework which monitors, mitigates and manages the risks to which Challenger is exposed.

Challenger's Board recognises the broad range of risks that apply to participants in the financial services industry. These include funding and liquidity risk, investment and pricing risk, counterparty risk, business and reputational risk, operational risk, licence and regulatory risk, cyber and information security risk and environmental and social risks. Increasingly, the risk of climate change is being considered within the investment process. Challenger invests in assets with long-term cash flows to match the annuity payments required to be made within its portfolio. This means that Challenger must consider the risk of climate change within its risk management framework and work to ensure that this risk is mitigated where possible. Challenger is currently not materially exposed to climate risk.

5 Challenger's 1H20 strategic progress

1H20 strategic progress

Progress in 1H20 against strategic priorities is set out below:

Increase the use of secure retirement income streams

Industry lifetime annuity sales currently represent less than 2% of the annual transfer from the retirement savings (accumulation) phase to the retirement spending (retirement) phase. Challenger is focused on growing the allocation of Australian retirement savings to secure and stable incomes.

1H20 progress:

- Total Life sales up 15% with annuity sales down 9% offset by a 97% increase in Other Life sales;
- Annuity sales saw the following outcomes in Australia and Japan:
  - Australian annuity sales down 24%:
    - Domestic term annuities sales down 16% - impacted by Australian financial advice market and industry disruption; and
    - Lifetime annuity sales down 52% - impacted by the transition to new means test rules and disruption to the Australian financial advice market.
  - Japan annuity sales up 169% driven by an expanded reinsurance agreement with MS Primary extending reinsurance to include US dollar annuities in addition to Australian dollar annuities.
- Other Life sales, representing Challenger's Guaranteed Index Return (GIR) product and the Challenger Index Plus Fund, up 97% driven by strong demand from superannuation and institutional clients seeking guaranteed returns in the low interest rate environment.

Australian financial advice market disruption

In 1H20, Challenger's Australian annuity sales continued to be impacted by disruption to the Australian financial advice and wealth management industry following the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. This has resulted in a significant reduction in Australian financial adviser numbers and has increased the movement of advisers across licensees. Major advice hubs have also been subject to client remediation projects and in some cases businesses have been closed or restructured. The advice practices of major banks have been severely affected.

This has led to lower new client acquisitions by third party financial advisers, which in turn is impacting Challenger annuity sales.

Challenger believes in the need for financial advice, particularly in the retirement phase and is supporting advisers as they move across licensees and ensuring Challenger products are widely available on investment and administration platforms.

Transition to new means test rules

In addition to the disruption currently occurring in the Australian financial advice market, Challenger's 1H20 lifetime annuity sales were also affected by the transition to new age pension means test rules that commenced on 1 July 2019.

The new rules are designed to support the take-up of lifetime income stream products.

Australian lifetime annuity sales decreased 52% on 1H19, with sales of Liquid Lifetime down 47% and CarePlus sales down 60%.

For Liquid Lifetime, the Regular option is generally less attractive under the new means test rules for customers for whom the age pension is a consideration, and the Flexible and Enhanced options are supported by the new rules. The Flexible and Enhanced options offer a different client proposition by providing longevity protection with lower liquidity options. Advisers are transitioning from the Regular to the Flexible and Enhanced options and a new cohort of advisers writing the Flexible and Enhanced options is emerging.

For CarePlus, the product has been reviewed and updated following the commencement of new means test rules. The regulatory change was one factor in the review which focused on providing the best overall product and outcomes for aged care customers.

The new means test rules have been designed to support the take up of longevity protection and lifetime income streams. Challenger remains confident over the long-term that lifetime sales will increase under the new means test rules.

Lifetime sales in the second quarter of FY20 were up 22% on the first quarter.

Diversifying distribution channels

Challenger is focused on diversifying its distribution channels and reducing reliance on Australian retail financial advisers. In 1H20, the following initiatives were undertaken:

- Commenced reinsuring US dollar annuities issued by MS Primary in Japan. As a result, MS Primary 1H20 sales increased by 169% and represented 24% of total annuity sales, up from 8% in 1H19;
- Expanded institutional relationships to include a new institutional annuity client, investing $300m across a range of term annuities; and
- Grew its Guaranteed Index Return client base.

5 Challenger's 1H20 strategic progress (continued)

1H20 strategic progress (continued)

Increase the use of secure retirement income streams (continued)	**Life sales mix and focus on long-term products** Challenger's annuity sales mix continues to evolve toward long-term products. Long-term annuities embed more value for shareholders as they lengthen the tenor of the annuity book, improve the maturity profile and typically enhance return on equity. In 1H20, long-term annuity sales, which include Australian lifetime annuities and 20-year fixed term annuities distributed through MS Primary in Japan, represented 35% of total annuity sales (1H19 29%). The annuity book continues to shift toward long-term annuities, with the long-term annuity book now the same size as the fixed term annuity book. **Retirement reforms engagement and advocacy** The Australian Government is considering a range of superannuation reforms aimed at enhancing the retirement phase of superannuation. The Government announced a Retirement Income Framework in May 2018. The first stage of the proposed Retirement Income Framework is to include a Retirement Income Covenant in the *Superannuation Industry (Supervision) Act 1993*, which would require superannuation trustees to have a retirement income strategy in place for members from 1 July 2020. The second stage of the framework is to develop simplified, standardised metrics in product disclosures to help members make decisions about the most appropriate retirement income product for them. The Government consulted on disclosure in late 2018 and has indicated consumer testing will be undertaken on the design and content of product disclosures. On 1 July 2019, new pension means test rules commenced for lifetime income stream products. The new means test rules were designed to encourage the development of innovative lifetime income products that will help retirees manage the risk of outliving their savings, while ensuring a fair and consistent means test treatment for all retirement income products. On 27 September 2019, the Government announced a review into the retirement income system. The review will establish a fact base of the current retirement income system and improve understanding of its operation and the outcomes it is delivering for Australian retirees. A consultation paper was released in November 2019 with the final report expected to be provided to the Government by June 2020. **Maintaining thought leadership position** As an Australian retirement income thought leader, Challenger works with a broad range of industry, consumer and Government organisations to assist in developing retirement income policy outcomes that help provide Australians with financial security for retirement. In 1H20, Challenger partnered with National Seniors Australia to measure retirees' attitudes to and confidence in managing the financial aspects of retirement. Challenger also partnered with the Council on the Ageing (COTA) New South Wales in 1H20 to explore consumer-related retirement income issues.
Lead the retirement incomes market and be the partner of choice	Challenger's strategy includes being the partner of choice for superannuation fund advisers, wealth managers and investment platforms in providing retirement income solutions. Challenger is the market leader in annuities with 76%[1] market share. 1H20 progress: **Leading adviser ratings** Despite the adviser and industry disruption underway and new competitors entering the retirement income market, Challenger has remained the dominant retirement income brand in 1H20. Among Australian financial advisers, Challenger continues to be the most recognised retirement income provider with 93%[2] of financial advisers rating Challenger as a leader in retirement income. Challenger's retirement income leadership position, which supports new distribution and product relationships, is 41 percentage points above its nearest competitor. **Increased product access via investment and administration platforms** Challenger's strategic priorities include making its annuity products available on leading investment and administration platforms to allow financial advisers and their customers easy and efficient access to Challenger annuities. By making Challenger annuities available via investment and administration platforms, advisers and superannuation funds can more easily create solutions that combine lifetime income streams with other products, such as account-based pensions. Challenger annuities continue to be available to over 70% of Australian financial advisers via their primary investment and administration platform, which includes a wide range of traditional major retail hub platforms and independent platforms.

[1] Plan for Life – September 2019 – based on annuities under administration at 30 September 2019.
[2] Marketing Pulse Adviser Study December 2019.

5 Challenger's 1H20 strategic progress (continued)

1H20 strategic progress (continued)

Lead the retirement incomes market and be the partner of choice (continued)	**New brand campaign** In June 2019, Challenger launched a new integrated brand campaign based on extensive adviser and customer research. Customer research showed that improving understanding of annuities leads to a higher consideration of them in retirement. The new integrated campaign focuses on building brand awareness and familiarity, with a strong emphasis on educating customers on annuities being an important component when creating confidence in retirement. Campaign performance indicators show an increase in brand awareness of +10 percentage points and familiarity of +6 percentage points amongst Challenger's target audience of retirees aged 65 to 74. The campaign results are also positive in terms of customer education including very strong interest in retirement and annuities content. Click through rates and time spent on relevant pages significantly exceeds industry benchmarks. **Investing in distribution, product and marketing growth initiatives** In FY20 Challenger will invest up to $15 million across a range of initiatives to drive long-term annuity sales growth. In 1H20, $6 million of this investment has been undertaken. The initiatives focus on building additional bottom-up customer demand, increasing the allocation made to annuities through financial advice and broadening distribution and institutional partnerships. Initiatives to build bottom-up customer demand focus on enhancing customer engagement and educating customers and potential customers on the benefits of including an annuity in their portfolio. Challenger's annuity products have also been simplified to support increased self-direction and easier allocation to annuities made through financial advice. The wealth management and financial advice industry has developed over many years with a focus on the superannuation savings (or accumulation) phase of superannuation. The industry is searching for retirement advice solutions to help provide appropriate retirement advice. As one of Australia's leading retirement income brands and a widely recognised thought leadership capability, Challenger has a role to play in helping to develop industry retirement advice solutions. Initiatives to increase the allocation made to annuities through financial advice focus on improving the integration of annuities into the advice process through the development of a range of tools and services. Challenger is focused on broadening its distribution channels, including partnering with profit-for-member funds. Profit-for-member funds are increasing their focus on providing retirement income solutions for their members and can partner with Challenger to provide guaranteed income solutions to their members.
Provide customers with excellent funds management solutions	Challenger is focused on providing excellent funds management solutions in order to help build retirement savings. 1H20 progress: **Maintaining superior investment performance** Funds Management has a long track record of achieving superior investment performance, which has helped in attracting strong net flows. Long-term performance for Fidante Partners Australian boutiques remains strong with 91% of FUM outperforming benchmark over five years. Over one year, 85% of FUM outperformed benchmark[1]. Since inception, 89% of Fidante Partners' funds have achieved either first or second quartile investment performance [2]. **Award-winning investment strategies** Fidante Partners' investment managers continue to be externally recognised. During 1H20, the following funds won investment manager awards: • Ardea Investment Management – Zenith Fund Awards Australian Fixed Income winner (2019); • Ardea Investment Management – Kanganews Australian Rates Fund Manager of the Year (2019); and • Kapstream – Kanganews Australian Credit Fund Manager of the Year (2019). **Highly rated retail investment products** Fidante Partners' investment managers and funds are highly rated by external asset consultants: • 40% of ratings are the top rating (e.g. 'Highly Recommended' or 'Gold') compared to an average of approximately 10% across the Australian funds management industry; and • 91% of ratings are a 'buy' rating compared to an average of approximately 70% across the Australian funds management industry.

[1] As at 31 December 2019. Percentage of Fidante Partners Australian boutiques meeting or exceeding performance benchmarks.
[2] Mercer as at December 2019.

5 Challenger's 1H20 strategic progress (continued)

1H20 strategic progress (continued)

Provide customers with excellent funds management solutions (continued)

The quality and performance of Fidante Partners' investment managers and funds continues to receive strong independent validation. During 1H20, two of Alphinity Investment Management's Australian share funds were upgraded from Recommended to Highly Recommended. Eiger Capital was also awarded a 'Highly Recommended' rating and Greencape Capital became the only Australian large cap equities manager to hold the top rating across all three major Australian retail research consultants.

Adding new boutiques and investment strategies

Fidante Partners continues to expand its product offering by adding new boutiques, forming new partnerships and developing new investment strategies for existing managers.

In September 2019, Fidante Partners and global alternative asset manager Ares Management Corporation (NYSE: ARES) established a new strategic joint venture, Ares Australia Management. The joint venture will provide Australian investors with access to alternative investment products managed by Ares Management Corporation.

During 1H20, Fidante Partners expanded its product offering through:

- Ardea launching Ardea Pure Alpha, which is a higher returning version of the flagship Ardea Real Outcome Fund;
- Kapstream launching a retail share class for the Kapstream Absolute Return Income Plus strategy, which targets an absolute return of 3–4% above the cash rate; and
- Whitehelm Capital launching the Whitehelm Global Listed Infrastructure Fund for Australian investors which has previously only been available in Europe

Expanding distribution channels through active ETF market

There continues to be strong demand from investors for simple and easy-to-access liquid investment products. Exchange Traded Funds (ETFs) have experienced strong growth in a number of markets as they provide the ability to deliver diversified investment strategies in a liquid and simple-to-execute format. ETFs have traditionally focused on passive or factor-based investments; however, Funds Management has identified an opportunity to expand ETF usage into active manager products.

In October 2019, Fidante Partners launched its second ETF in the ActiveX Series, the ActiveX Kapstream Absolute Return Income Fund. The fund aims to provide a steady stream of income and capital stability over the medium term while outperforming its benchmark through different market cycles.

Fidante Partners is committed to growing the ActiveX Series and expects to launch more active ETFs.

CIP Credit Income Fund

CIP Fixed Income manages funds and investment mandates across multiple underlying investment strategies composing both public and private credit investments in the Australian market.

The CIP Credit Income Fund, launched in October 2017, is a floating rate, multi-sector credit income strategy that invests across high quality, predominantly investment grade public and private debt investments. With an investment-grade average portfolio credit rating[1], the fund provides investors with a higher income, defensive and diversified portfolio without taking excessive levels of credit or interest rate risk.

In 1H20, the CIP Credit Income Fund continued to attract interest from third party institutions. CIP also expanded distribution of the fund in 1H20 to target Australian high-net-worth investors.

The fund continues to perform strongly and, since inception in October 2017, has outperformed its benchmark target of 3% above the Bank Bill rate.

The CIP Credit Income Fund FUM at 31 December 2019 was $270 million and increased by 69% ($108 million) in 1H20.

CIP appointed ABSF investment manager

In December 2019, the Australian Office of Financial Management (AOFM) appointed CIP as the investment adviser to assist with the evaluation of investment proposals and provide ongoing portfolio management services for the Federal Government's Australian Business Securitisation Fund (ABSF). The ABSF was established to improve access to credit for Australian small businesses. CIP will provide advisory services and generate transaction and investment management fees from the ABSF.

CIP Real Estate

The CIP Real Estate team manage real estate mandates across Australia and Japan on behalf of Australian and international investors. CIP has recently expanded its Japanese real estate management capability, which includes directly managing Life's $0.8 billion Japanese retail portfolio.

CIP have identified attractive investment opportunities in Japan and are currently executing an investment program for domestic and international clients.

[1] Based on Moody's Investors Service Inc. weighted average-rating factors.

5 Challenger's 1H20 strategic progress (continued)

1H20 strategic progress (continued)

Maintain leading operational and people practices

Challenger believes maintaining a highly engaged, diverse and agile workforce committed to sustainable business practices with a strong risk and compliance culture is essential for providing customers and shareholders with superior outcomes.

1H20 progress:

Redefining Challenger's values
Challenger's values are integral to its culture and linked to everything employees do. They set out the behaviours needed to meet community expectations and ensure Challenger can deliver on its vision and strategy, now and in the future.

In 1H20, Challenger redefined and launched new values:

- Act with integrity;
- Aim high;
- Collaborate; and
- Think customer.

The new Challenger values are clear, meaningful and memorable and define what is expected of all employees.

Employee engagement and risk culture
Employee engagement measures the nature of the relationship between an organisation and its employees. Challenger believes having a highly engaged team with a positive attitude towards the organisation and its values will lead to superior shareholder and customer outcomes.

Challenger measures employee engagement through an annual survey, which was last conducted by Willis Towers Watson in March 2019, and recorded a sustainable employee engagement score of 84%. The result was above both the Australian Company and Global Financial Services Norm.

Diversity and inclusion
Challenger believes that diversity and inclusion delivers better outcomes for its people, its business and the community. In July 2019, Challenger updated its diversity and inclusion strategy to focus on three key areas:

1. Providing a diverse and inclusive workplace;
2. Gender equality; and
3. Supporting employment outcomes for people aged over 50.

New employee-led diversity and inclusion working groups have also been established to focus on driving change in areas that matter most to employees.

To encourage greater representation of women at senior levels of the organisation, Challenger continues to develop initiatives targeted at improving gender equality, including setting gender diversity targets. Challenger set diversity targets in December 2015, which included a target of 38% of management roles being held by women by the end of FY20. In FY19, the FY20 target for women in management roles was increased from 38% to 40%. At 31 December 2019, Challenger had 37% of management roles held by women.

Challenger is committed to pay equity. Management and the Board review gender pay equity annually as part of the remuneration process. This focus has ensured that for the past five years gender pay equity for similar roles has been maintained.

In 1H20, Challenger was recognised as a global top 100 employer for gender equality in the 2019 Equileap Global Gender Equality rankings. This positions Challenger in the top 100 leading organisations that are making progress towards gender equality in the workplace.

Flexible work
Challenger has a focus on providing its employees with flexibility. At 31 December 2019, 88 employees, representing approximately 12% of Challenger staff, were using formal flexible working arrangements. In addition, a large number of men and women have taken advantage of informal flexible work arrangements throughout the year.

5 Challenger's 1H20 strategic progress (continued)

1H20 strategic progress (continued)

Maintain leading operational and people practices (continued)

Maintain superior cost to income ratio

Challenger's business is highly scalable and efficient. Challenger's normalised cost to income ratio target is a range of 30% to 34%. In FY20, Challenger expects to exceed its normalised cost to income ratio target as a result of Distribution, Product and Marketing (DPM) growth initiatives being undertaken to drive demand for annuities. In FY20 Challenger expects to spend up to $15m on these growth initiatives.

Despite these additional costs, Challenger's cost to income ratio in 1H20 was 33.5% and is tracking better than expected. Challenger maintains one of the leading cost to income ratios in the Australian financial services industry.

Enhancing sustainability capability

Considering environmental, social and governance (ESG) risks and opportunities supports Challenger in delivering on its vision to provide financial security for retirement. Throughout 1H20, Challenger continued to make progress on implementing its sustainability strategy.

Challenger's long-term sustainable returns are achieved through the integration of ESG practices across the business.

Challenger continued to develop its ESG practices and supported Fidante Partners to develop ESG practices within their boutique fund managers. As a result, most boutiques have now become signatories to the United Nations Principles for Responsible Investment (PRI) and many boutique managers have developed standalone ESG policies.

In 1H20, Challenger provided opportunities for employees and boutiques to further understand ESG risks and opportunities through internal presentations and reporting. External experts also provided further insight on climate risk and considerations under the modern slavery legislation.

Challenger continues to be a constituent of the FTSE4Good Index and a signatory to the PRI.

In September 2019, Challenger announced a strategic three-year partnership with the Council of the Ageing (COTA) New South Wales. Through this partnership, Challenger will deliver a community program aimed at addressing the underemployment of people over 50. Challenger understands that continuing to work as you age is a key driver for financial security in retirement. This program will celebrate the value older Australians bring to the workplace and improve workplace practices to attract and retain older employees.

6 Market overview and outlook

Challenger is an investment management firm with a vision to provide its customers with financial security for retirement.

Challenger has two businesses, Life and Funds Management, which both provide products for Australia's fast-growing superannuation system.

Australia's superannuation system commenced in 1992 and is now the fourth largest pension system globally, with pension assets increasing by 10% per annum over the past 20 years[1].

Growth in Australia's superannuation system is underpinned by mandatory contributions, which are scheduled to increase from the current rate of 9.5% of gross salaries to 12.0% by 2025. The superannuation system is forecast to grow from $2.9 trillion today[2] to almost $7 trillion over the next 15 years[3]. Growth in the superannuation system is also supported by changing demographics and the Government's focus on enhancing the retirement phase of superannuation.

Both Life and Funds Management are expected to benefit from the long-term growth in Australia's superannuation system.

Life outlook

Life focuses on the retirement spending phase of superannuation by providing products that convert retirement savings into safe and secure income. Challenger Life is Australia's leading provider of annuities[4].

The retirement spending phase of superannuation is expected to grow strongly over the next 20 years driven by demographic changes and maturing of the superannuation system.

The number of Australians over the age of 65, which is Life's target market, is expected to increase by over 50% over the next 20 years[5]. Reflecting these demographic changes, and growth in the superannuation system, the annual transfer from the retirement savings phase of superannuation to the retirement spending phase was estimated to be approximately $70bn[6] in 2019. Industry annuity sales (term and lifetime annuities) in Australia currently represent approximately 4% of the annual transfer to the retirement phase, with lifetime annuities currently representing less than 2%.

There is growing recognition that retirees need to take a different approach to investing in retirement. With the transition from Government-funded age pensions to private pensions, retirees are demanding safe, secure retirement income products that convert savings into income and provide financial security.

The superannuation system is helping Australians build savings for their retirement. Australians now have meaningful superannuation balances when they retire, with an estimated average total financial wealth at retirement of $680,000[7], despite the system being in place for only half the working life of today's retirees.

There are a range of Government retirement income regulatory reforms that are being implemented and currently proposed. These reforms are designed to enhance the retirement phase and better align it with the overall objective of the superannuation system to provide income in retirement to substitute or supplement the Government-funded age pension.

These retirement income reforms provide a significant opportunity to increase the proportion of retirement savings invested in longevity products, including annuities.

As Australia's leading provider of annuities, Challenger Life is expected to continue to benefit from the long-term growth in Australia's superannuation system and regulatory reforms designed to enhance the retirement phase.

In 1H20, in response to industry and market distribution, Life initiated a range of initiatives to help build more bottom-up customer demand for annuities and to increase the allocation of retirement savings made to annuities.

Life is also diversifying its range of products and expanding its distribution relationships in both Australia and Japan.

In Australia, Life is broadening access by making annuities available via leading investment and administration platforms. Challenger's range of annuities are accessible by more than 70% of Australia's financial advisers via their primary investment and administration platform.

Challenger has been recognised as a retirement income product innovator and has won the Association of Financial Advisers 'Annuity Provider of the Year' for the last 12 years.

Challenger remains the dominant retirement income brand in Australia and is recognised by 93%[8] of financial advisers as a leader in retirement incomes.

Life is well-positioned to capture long-term growth opportunities through increased superannuation savings and a greater allocation of retirement savings made to annuities.

Life relies on third party financial advisers, both independent and part of the major advice hubs[9], to distribute its products to retail customers in Australia. Following the public hearings and completion of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission) in 2019, there has been significant disruption across the Australian financial advice market which has reduced customer confidence in financial advice and reduced the acquisition of new customers by third party financial advisers. The financial advice market disruption has impacted Australian wealth management industry sales and is expected to be ongoing throughout 2020.

While Challenger was not called to give evidence at the Royal Commission, nor were Life's customers questioning the quality of its products or services, the disrupted Australian financial advice market is impacting third party financial adviser productivity and reducing the number of financial advisers especially at the major-bank aligned advice groups. This has impacted Life's domestic annuity sales which fell by 24% in 1H20 compared to 1H19.

Life has a strong reputation with both consumers and advisers and has implemented a range of initiatives to support sales while the Australian financial advice market is being disrupted. Life is engaging and educating customers in order to increase consumer understanding of annuities and build additional customer bottom-up demand. Initiatives include enhancing and simplifying its product offering, developing engagement and education initiatives and nurturing prospective clients.

[1] Willis Towers Watson Global Pension Study 2019.
[2] APRA, as at September 2019.
[3] Rice Warner 2019 superannuation projections.
[4] Plan for Life – September 2019 – based on annuities under administration at 30 September 2019.
[5] 2020 – 2040 comparison based on Australian Bureau of Statistics population projections series B, Cat No 3222.0.
[6] Australian Taxation Office.
[7] Australian Bureau of Statistic Household Income and Wealth 2017-18 Cat No 6523.0. Average household wealth includes superannuation and non-superannuation assets and excludes the family home.
[8] Market Pulse Adviser Study December 2019.
[9] Major advice hubs include AMP and the wealth management operations of the major Australian banks.

6 Market overview and outlook (continued)

Following the Royal Commission, the Australian financial advice landscape has been evolving, providing an opportunity to improve the adviser experience. Challenger is evolving its service model and has a range of initiatives under way to support advisers.

The profit-for-member sector of the superannuation system is growing strongly and currently represents approximately 26% of total superannuation assets[1]. As members transition to retirement, focus by profit-for-member funds to provide comprehensive retirement income solutions to members is increasing. The profit-for-member sector provides a significant growth opportunity for Challenger.

In Japan, Life commenced an annuity relationship with Mitsui Sumitomo Primary Life Insurance Company Limited (MS Primary) to provide Australian-dollar annuities in November 2016. MS Primary is a leading provider of annuity products in Japan and part of MS&AD Insurance Group Holdings Inc. (MS&AD).

As part of the reinsurance agreement with MS Primary, Challenger Life reinsures both an Australian-dollar and US-dollar 20-year term product and both an Australian-dollar and US-dollar lifetime annuity product.

Under the new reinsurance arrangement, MS Primary will provide Challenger an annual amount of reinsurance, across both Australian and US-dollar annuities, of at least ¥50 billion (~A$660 million) per year for a minimum of 5 years[2,3]. This is subject to review in the event of a material adverse change for either MS Primary or Challenger Life.

At 31 December 2019, MS&AD held ~16% of Challenger's issued capital. A representative from MS&AD, Mr Masahiko Kobayashi, was appointed as a Non-Executive Director of Challenger Limited in August 2019. Mr Hiroyuki Iioka was also appointed as an Alternate Director to Mr Kobayashi on 13 December 2019.

Funds Management outlook

Funds Management focuses on building savings for retirement by providing investment strategies that seek to deliver superior investment returns. Funds Management has operations in Australia, the United Kingdom and Japan and is one of Australia's largest active fund managers[4].

Growth in funds under management can be attributed to the strength of Challenger's retail and institutional distribution teams, a market-leading business model focused on investor alignment and strong long-term investment performance.

Funds Management comprises Fidante Partners and Challenger Investment Partners (CIP).

The Fidante Partners business model involves taking minority equity interests in separately branded boutique fund management firms, with Challenger providing distribution, administration and business support, leaving investment managers to focus on managing investment portfolios. Fidante Partners focuses on managers with high active share as opposed to managers whose investment portfolios only deviate slightly from the index in terms of composition.

Challenger's Fidante Partners business model has allowed it to attract and build successful active equity, active fixed income and alternative investment businesses.

Fidante Partners continues to expand its product offering by adding new boutiques and accessing new distribution channels.

In 2018, Fidante Partners launched the ActiveX Series of actively managed Exchange Traded Funds (ETFs) targeting the growing popularity of exchange traded products by providing easy access to the extensive expertise of Fidante Partners' boutique fund managers. The series currently features fixed income active ETFs from Ardea and Kapstream.

In September 2019, Fidante announced a new strategic joint venture with global alternative asset manager, Ares Management Corporation (NYSE: ARES). The joint venture will provide Australian investors with access to alternative investment products managed by Ares.

Challenger Investment Partners is an institutional manager that principally originates and manages fixed income and commercial real estate for leading global and Australian institutions, including Challenger Life.

The CIP Fixed Income team is a fundamentally driven, active investment manager that adopts a long-term focus. The team aims to provide diversified sources of income by seeking opportunities in both the public and private sectors, whilst maintaining capital stability.

The CIP Real Estate team is a large scale, institutional investment manager that provides customised solutions for clients through matching investment capital with opportunities. The team has expertise across both equity and debt, together with experience in public and private markets, which provides deep insights and a significant pipeline

Funds Management is also expanding its presence in Japan in order to support the MS&AD strategic relationship, management of Japanese real estate investments and to develop distribution opportunities in the region.

Funds Management is expected to continue to benefit from the overall growth in Australia's superannuation system and expansion into international funds management and pension markets.

Risks

The above outlook for the Life and Funds Management businesses is subject to the following key business risks :

- regulatory and political changes impacting financial services participants;
- demand for and competition with Challenger products, including annuities and managed funds;
- investment market volatility;
- general uncertainty around the global economy and its impact on markets in which Challenger operates and invests; and
- operational risk.

[1] APRA Quarterly Superannuation Performance Statistics, September 2019. Represents industry superannuation as a percentage of total superannuation assets.

[2] Challenger Life entered into a new agreement with MS Primary to commence reinsuring the US dollar version of the 20-year term product from 1 July 2019. Challenger will provide a guaranteed interest rate and assume the investment risk in relation to those policies issued by MS Primary and reinsured by Challenger.

[3] Based on the exchange rate as at 31 December 2019.

[4] Consolidated FUM for Australian Fund Managers – Rainmaker Roundup, September 2019.

7 Key Performance Indicators (KPIs)

7.1 Profitability and growth

KPIs for the period ended 31 December 2019 (with the 6 months to 31 December 2018 being the prior comparative period (pcp), unless otherwise stated) include:

	31 Dec 2019	31 Dec 2018	Change %
Profitability			
Statutory profit attributable to equity holders ($m)	220.4	6.1	large
Normalised NPBT ($m)	278.6	270.0	3.2
Normalised NPAT ($m)	191.4	199.8	(4.2)
Statutory EPS (cents)	36.3	1.0	large
Normalised EPS (cents)	31.5	33.1	(4.8)
Interim dividend (cents)	17.5	17.5	-
Interim dividend franking	100%	100%	-
Normalised cost: income ratio	33.5%	32.7%	0.8
Statutory RoE after tax	12.0%	0.3%	11.7
Normalised RoE pre-tax	15.2%	15.6%	(0.4)
Normalised RoE after tax	10.4%	11.5%	(1.1)
Growth			
Total Life annuity sales ($m)	1,956.9	2,140.5	(8.6)
Other Life sales	1,182.2	599.8	97.1
Total Life sales	3,139.1	2,740.3	14.6
Total Life flows ($m)	923.6	583.7	58.2
Total Life book growth (%)	6.2%	4.2%	2.0
Total FM net flows ($bn)	1.9	(1.0)	large
Total AUM ($bn)	86.4	78.4	10.2

Challenger's $220.4 million statutory profit attributable to equity holders was significantly higher than the prior comparative period, primarily as a result of higher investment experience. This is explained further in Section 8.

Normalised net profit after tax decreased by 4.2% compared to the prior period, reflecting higher Life cash operating earnings and Funds Management net fee income offset by higher expenses and a higher effective tax rate.

An interim dividend of 17.5 cents was announced, franked at 100%, consistent with the pcp.

Challenger's normalised cost to income ratio of 33.5% remains within the targeted range and is higher than the ratio in the prior period (32.7%), primarily as a result of increased costs in Distribution, Product and Marketing to support growth initiatives.

Challenger's expected medium-term normalised cost to income ratio target is 30–34%.

Statutory return on equity (RoE) after tax of 12.0% has increased compared to the prior period (31 December 2018: 0.3%) as a result of higher after-tax statutory profit. Normalised RoE after tax decreased from 11.5% in the prior period to 10.4% primarily reflecting the lower normalised net profit after tax.

7.2 Capital management

Challenger's capital position is managed at both the Group and the prudentially-regulated Challenger Life Company Limited (CLC) level, with the objective of maintaining the financial stability of the Group and CLC whilst ensuring that shareholders earn an appropriate risk adjusted return. Refer to Note 9 Contributed equity for further information on the Group's Internal Capital Adequacy Assessment Process.

The following table highlights the key capital metrics for CLC and the Group:

Capital	31 Dec 2019	31 Dec 2018	Change
Net assets attributable to equity holders ($m)	3,715.8	3,387.9	327.9
CLC excess capital over PCA ($m)	1,406.3	1,303.6	102.7
Group cash ($m)	141.2	87.7	53.5
CLC excess capital over PCA + Group cash ($m)	1,547.5	1,391.3	156.2
CLC PCA ratio (times)	1.54	1.54	-
CLC Tier 1 ratio (times)	1.38	1.37	0.01

CLC regulatory capital base

CLC holds capital in order to ensure that, under a range of adverse scenarios, it can continue to meet its regulatory and contractual obligations to its customers. CLC is regulated by APRA and is required to hold a minimum level of regulatory capital. CLC has ongoing and open engagement with APRA.

CLC maintains a level of capital representing the Prescribed Capital Amount (PCA) plus a target surplus. The target surplus is a level of excess capital that CLC seeks to carry over and above APRA's minimum requirement in order to provide a buffer against adverse market conditions, having regard for CLC's credit rating.

CLC uses internal capital models to determine its target surplus, which are risk-based and responsive to changes in CLC's asset allocation and market conditions. While CLC does not target a specific PCA ratio, under current circumstances CLC's internal capital models result in a PCA ratio in the range of 1.3 to 1.6 times. This range may change over time and is dependent on a number of factors. CLC's PCA ratio was 1.54 times at 31 December 2019, consistent with the pcp.

In addition to CLC's excess regulatory capital, Challenger maintains cash at a Group level which can be used to meet regulatory capital requirements. Challenger further maintains a Group corporate debt facility of $400 million in order to provide additional financial flexibility. The facility remained undrawn throughout the period.

7 Key Performance Indicators (KPIs) (continued)

7.2 Capital management (continued)

APRA's Level 3 (conglomerate) proposals

The Group is a Level 3 Head (as defined in Prudential Standard 3PS 001) under the APRA conglomerates framework. Level 3 groups are groups of companies that perform material activities across more than one APRA-regulated industry and/or in one or more non-APRA regulated industries. APRA's non capital conglomerate prudential standards relating to measurement, management, monitoring, reporting aggregate risk exposures and intragroup transactions and exposures came into effect from 1 July 2017.

In March 2016, APRA announced that it would defer the implementation of conglomerate capital requirements until a number of other domestic and international policy initiatives were further progressed. There has been no further update from APRA in relation to this position.

Dividends and dividend reinvestment plan

Dividends	31 Dec 2019	31 Dec 2018	Change %
Interim dividend (cents)	17.5	17.5	-
Interim dividend franking	100%	100%	-
Normalised dividend payout ratio	55.5%	52.9%	5.0

The Board targets a dividend payout ratio of 45% to 50% of normalised profit after tax. The normalised dividend payout ratio for the period ended 31 December 2019 was above this range at 55.5% (31 December 2018: 52.9%).

The payout ratio currently exceeds the target, reflecting the resilience of Challenger's business and its strong capital position.

The Company also seeks to frank its dividend to the maximum extent possible and expects future dividends over the medium term to be fully franked. However, the actual dividend payout ratio and franking will depend on prevailing market conditions and capital allocation priorities at the time.

The Company continued to operate its dividend reinvestment plan (DRP) during the period. The DRP participation rate for the 2019 final dividend was 2.3% of all issued shares, and 364,482 ordinary shares were issued to satisfy the DRP requirements on 25 September 2019.

The DRP will continue for the 2020 interim dividend and the Board has determined that new shares will be issued to fulfil DRP requirements in respect to the interim dividend. The new shares will not be issued at a discount to the prevailing Challenger share price.

No shares were bought back during the period.

7.3 Credit ratings

Challenger Limited and CLC are rated by Standard & Poor's (S&P). In November 2019, S&P reaffirmed both Challenger Limited and CLC's credit ratings.

Ratings were confirmed as:

- CLC: 'A' with a positive outlook; and
- Challenger Limited: 'BBB+' with a positive outlook.

The S&P ratings reflect the financial strength of Challenger Limited and CLC. In particular, S&P has noted that CLC has an extremely strong capital and earnings position with significant financial flexibility.

8 Normalised profit and investment experience

Normalised framework (Non IFRS)

CLC and its consolidated entities are required by AASB 1038 *Life Insurance Contracts* to value all assets and liabilities at fair value where permitted by other accounting standards.

This gives rise to fluctuating valuation movements on assets and liabilities being recognised in the profit and loss in CLC and on consolidation in Challenger Limited. CLC is generally a long-term holder of assets, due to holding assets to match the term of life contract liabilities. As a result, Challenger takes a long-term view of the expected capital growth of the portfolio rather than focusing on short-term movements. Investment experience represents the difference between actual investment gains/losses (both realised and unrealised) and expected gains/losses based on CLC's medium to long-term expected returns together with the new business strain[1] that results from writing new annuities. Investment experience also includes any impact from changes in economic and other actuarial assumptions.

A reconciliation between statutory revenue and the management view of revenue and net income is included in the financial report as part of Note 3 Segment information. This note also includes a reconciliation of statutory profit after tax and normalised net profit after tax (the management view of post-tax profit). The application of the normalised profit framework has been reviewed by Challenger's independent auditor to ensure that the reported results are consistently applied in accordance with the methodology described in Note 3 Segment information in the financial report.

[1] New business strain is a non-cash valuation adjustment which reflects annuity rates on new business being higher than the risk-free rate and an illiquidity premium used to fair value annuities together with certain maintenance expenses. The new business strain reverses over the annuity contract.

8 Normalised profit and investment experience (continued)

Management analysis – normalised results

	31 Dec 2019 $m	31 Dec 2018 $m	Change $m	Change %
Net income[1]	422.7	405.3	17.4	4.3
Comprising:				
– Life normalised COE	344.8	329.6	15.2	4.6
– FM net income	77.7	75.2	2.5	3.4
– Corporate and other income	0.2	0.5	(0.3)	(60.0)
Operating expenses[1]	(141.6)	(132.4)	(9.2)	6.9
Normalised EBIT	**281.1**	**272.9**	**8.2**	**3.0**
Comprising:				
– Life normalised EBIT	285.8	277.9	7.9	2.8
– FM normalised EBIT	27.9	26.1	1.8	7.0
– Corporate and other normalised EBIT	(32.6)	(31.1)	(1.5)	4.8
Interest and borrowing costs	(2.5)	(2.9)	0.4	13.8
Tax on normalised profit	(87.2)	(70.2)	(17.0)	(24.2)
Normalised NPAT	**191.4**	**199.8**	**(8.4)**	**(4.2)**
Investment experience after tax	38.4	(193.7)	232.1	large
Significant items after tax	(9.4)	-	(9.4)	(large)
Statutory net profit after tax attributable to equity holders	**220.4**	**6.1**	**214.3**	**large**

[1] 'Net income' and 'Operating expenses' are internal classifications and are defined in Note 3 Segment information in the financial report. These differ from the statutory revenue and expenses classifications, as certain costs (including distribution expenses, property expenses, management fees, special purpose vehicle expenses and finance costs) are netted off against gross revenues. These classifications have been made in the Directors' report and in Note 3 Segment information to reflect how management measures business performance. Whilst the allocation of amounts to the above items and investment experience differ to the statutory view, both approaches result in the same total net profit after tax attributable to equity holders.

Life normalised cash operating earnings (COE) and earnings before interest and tax (EBIT) increased as a result of higher Life investment assets together with higher earnings from the fixed income portfolio and increased distributions from the equity portfolio when compared to the pcp. Life's average assets under management (AUM) increased by 6.3% as a result of the net book growth in annuities, net flows on external unit holders' liabilities and valuation movements on those assets.

Funds Management net income increased (up $2.5 million) due to increased performance fees and management and transaction fee revenue, together with increased equity accounted profits and distribution fee revenue. Funds Management average FUM increased by 6.2% as a result of mark-to-market gains on investments and net inflows over the period.

Operating expenses increased by $9.2 million (6.9%) for the period ended 31 December 2019. Challenger's employee numbers increased by 42 (or 6.2%) to 717 (on a full-time equivalent basis) when compared to the prior corresponding period.

Normalised tax for the period was $87.2 million, reflecting a normalised effective tax rate for the period of 31.3% (26.0% at 31 December 2018). The normalised effective tax rate was elevated for the period due to the relative composition of domestic and offshore earnings and respective tax rate differentials, lower utilisation of available group losses and the non-deductible interest on Challenger Capital Note instruments.

Significant items were negative $9.4 million (after tax) in the period; these represent non-recurring items. They include the impairment of an intangible asset recognised in relation to the revenue share interest owned in respect of Latigo Investment Partners ($6.6 million) and a boutique impairment charge and wind-up costs following the closure of FME Asset Management ($2.8 million).

Management analysis – investment experience

	31 Dec 2019 $m	31 Dec 2018 $m
Actual capital growth[1]		
– Cash and fixed income	32.6	(67.4)
– Infrastructure	35.8	4.1
– Property (net of debt)	23.4	38.9
– Equity and other investments	19.4	(110.2)
Total actual capital growth	**111.2**	**(134.6)**
Normalised capital growth[2]		
– Cash and fixed income	(22.6)	(20.8)
– Infrastructure	17.6	14.8
– Property (net of debt)	33.6	36.8
– Equity and other investments	42.0	47.3
Total normalised capital growth	**70.6**	**78.1**
Investment experience		
– Cash and fixed income	55.2	(46.6)
– Infrastructure	18.2	(10.7)
– Property (net of debt)	(10.2)	2.1
– Equity and other investments	(22.6)	(157.5)
– Policy liability experience[3]	14.3	(21.6)
Asset and policy liability experience	54.9	(234.3)
New business strain[4]	1.0	(35.9)
Investment experience before tax	55.9	(270.2)
Tax benefit/(expense)	(17.5)	76.5
Investment experience after tax	**38.4**	**(193.7)**

[1] Actual capital growth represents net realised and unrealised capital gains or losses and includes the attribution of interest rate, inflation and foreign exchange derivatives that are used to hedge exposures.
[2] Normalised capital growth is determined by multiplying the normalised capital growth rate for each asset class by the average investment assets for the period. The normalised capital growth rates represent Challenger's expectations for each asset class over the investment cycle. The annual normalised growth rate is +3.5% for equity (+4.5% in pcp) and other investments, +4.0% for infrastructure, +2.0% for property, and -0.35% for cash and fixed income in order to allow for credit defaults. The rates have been set with reference to medium to long-term market growth rates and are reviewed to ensure consistency with prevailing market experience.
[3] Policy liability experience represents the impact of changes in macroeconomic variables including bond yields, inflation factors, expense assumptions and other factors applied in the valuation of life contract liabilities.
[4] New business strain is a non-cash accounting adjustment recognised when annuity rates on new business are higher than the risk-free rate and an illiquidity premium used to fair value annuities together with certain maintenance expenses. The new business strain unwinds over the annuity contract.

8 Normalised profit and investment experience (continued)

Management analysis – investment experience (continued)

Investment experience after tax relates to changes in the fair value of Life's assets and liabilities. Investment experience is a mechanism employed to remove the volatility arising from asset and liability valuation movements and new business strain from Life business earnings so as to more accurately reflect the underlying performance of the Life business.

Pre-tax investment experience for the period comprised an asset and policyholder liability experience gain of $54.9 million and a gain of $1 million from Life's new business strain. All of Life's asset portfolios experienced fair value gains. These gains are largely unrealised and were primarily due to the improvement of fixed income, property and equity markets during the period.

9 Life segment results

The Life segment includes CLC, Australia's leading provider of annuities and guaranteed retirement income products. CLC has won the Association of Financial Advisers/Plan for Life annuity provider of the year for the past twelve consecutive years.

CLC is regulated by APRA and its financial strength is rated by S&P, with an 'A' credit rating and positive outlook. CLC is strongly capitalised, with significant excess capital above APRA's minimum regulatory requirements.

Life normalised results	31 Dec 2019 $m	31 Dec 2018 $m	Change $m	Change %
Normalised COE	344.8	329.6	15.2	4.6
– Cash earnings	274.2	251.5	22.7	9.0
– Normalised capital growth	70.6	78.1	(7.5)	(9.6)
Operating expenses	(59.0)	(51.7)	(7.3)	(14.2)
Normalised EBIT	**285.8**	**277.9**	**7.9**	**2.8**

Life normalised EBIT increased by $7.9 million (up 2.8%) due to higher normalised COE (up $15.2 million or 4.6%), which was partially offset by operating expenses increasing $7.3 million (or 14.2%). The higher normalised COE was the result of higher investment assets, with Life average investment assets increasing by 6.3%, offset by a lower COE margin. The lower margin was mainly attributable to lower normalised capital growth on the Equity and other portfolio following the reduction of the normalised capital growth expectation of 4.5% in the pcp to 3.5% from 1 July 2019.

Life generated a normalised return on equity (pre-tax) of 16.8%, down by 0.7 percentage points from the prior corresponding period as a result of higher normalised EBIT offset by increased average net assets.

Total Life sales increased from the prior period (up 14.6%), with increased fixed term sales (up 2.8%) and other Life sales (up 97.1%), offset by Lifetime sales (down 52.2%).

Lifetime sales reduced by 52.2% due to the transition to new means test rules for lifetime income streams (from 1 July 2019) and ongoing disruption to the wealth management and financial advice industry following the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

In November 2016, Life began issuing Australian dollar fixed rate annuities with a 20-year term to support its reinsurance agreement with MS Primary. Under the terms of the product, the customer can choose an annuity payment period of 5, 10, or 20 years with a benefit payable upon death. Challenger also announced in March 2019 that it will commence a quota share reinsurance of US dollar denominated annuities issued in the Japanese market by MS Primary from 1 July 2019. The arrangement provides CLC with an annual amount of reinsurance across both Australian and US dollar annuities of at least ¥50 billion (approximately A$660 million as at 31 December 2019) each year for a minimum of five years. The MSP reinsured sales comprised 24.1% of Life's total annuity sales in the period, which is a substantial increase on the prior corresponding period (8.2%) due to commencement of the reinsurance of US dollar annuities.

As part of the expansion of the reinsurance arrangement, MS&AD increased its shareholding in Challenger to ~16% and gained representation on Challenger's Board.

Life sales	31 Dec 2019 $m	31 Dec 2018 $m	Change $m	Change %
Fixed-term annuities	1,746.0	1,698.9	47.1	2.8
Lifetime annuities	210.9	441.6	(230.7)	(52.2)
Total Life annuity sales	1,956.9	2,140.5	(183.6)	(8.6)
Other Life sales	1,182.2	599.8	582.4	97.1
Total Life sales	**3,139.1**	**2,740.3**	**398.8**	**14.6**
Annuity net flows	93.6	493.5	(399.9)	(81.0)
Other Life net flows	830.0	90.2	739.8	large
Total Life net flows	**923.6**	**583.7**	**339.9**	**58.2**

Annuity net flows (new annuity sales less capital repayments) decreased by 81.0% to $93.6 million, driven by lower annuity sales and higher maturities. Based on the opening Life annuity book for the 2020 financial year ($12,870.2 million), annuity net book growth for the period was 0.7%, down from 4.2% in the prior period.

Other Life sales represent Guaranteed Index Return (GIR) mandates and the Challenger Index Plus Fund. Other Life sales increased as a result of new client sales during the period together with reinvestments of maturities.

Other Life net flows for the period were $830.0 million, increasing substantially compared to $90.2 million in the prior period. Total Life net flows were $923.6 million, representing total Life net book growth of 6.2% (31 December 2018: $583.7 million or 4.2% book growth).

10 Funds Management segment results

Challenger's Funds Management segment is one of Australia's largest[1] active fund managers.

Fidante Partners' multi-boutique platform comprises a number of separately branded funds management businesses. The model seeks to align the interests of investors, boutique investment managers and Fidante Partners.

The Funds Management model is delivering superior investment performance, with approximately 90% of funds achieving first or second quartile performance since inception.

Challenger Investment Partners (CIP) develops and manages assets under Challenger's brand for CLC and third-party institutional investors.

FM normalised results	31 Dec 2019 $m	31 Dec 2018 $m	Change $m	Change %
Net income	77.7	75.2	2.5	3.4
– Fidante Partners	45.5	46.3	(0.8)	(1.7)
– CIP	32.2	28.9	3.3	11.5
Operating expenses	(49.8)	(49.1)	(0.7)	1.4
Normalised EBIT	27.9	26.1	1.8	7.0

Funds Management normalised EBIT increased by 7.0% for the period, with increased net income offset by expense growth during the period.

Fidante Partners' net income includes distribution fees, transaction fees, administration fees and a share in the equity accounted profits for the boutique fund managers (inclusive of performance fees) in which it has an equity interest.

Fidante Partners' net income decreased for the period primarily as a result of lower transaction fees (down $2.6 million), which was partially offset by higher performance fees than in the prior period (up $1.0 million) and FUM based income (up $0.8 million).

CIP's net income increased due to higher transaction fees (up $2.2 million) together with higher net management fees (up $1.1 million).

Funds Management's normalised RoE (pre-tax) for the period was 23.8%, down by 0.6 percentage points from the prior period.

FM FUM and flows	31 Dec 2019 $bn	31 Dec 2018 $bn	Change $bn	Change %
Total FUM	82.8	75.0	7.8	10.4
– Fidante Partners	62.7	56.3	6.4	11.3
– CIP	20.1	18.7	1.4	7.5
Net flows	1.9	(1.0)	2.9	large
– Fidante Partners	1.9	(1.0)	3.0	large
– CIP	(0.1)	0.1	(0.1)	(large)

Funds Management FUM increased by $7.8 billion (10.4%) compared to the pcp.

During the period Fidante Partners' flows were positive $1.9 billion compared to a net outflow of $1.0 billion in the pcp. The net flows were supported by strong flows into both fixed income and equity boutiques.

11 Corporate and other segment results

The Corporate and other segment comprises central functions such as the Group executive, finance, treasury, legal, human resources, risk management and strategy.

The financial results also include interest received on Group cash balances and any interest and borrowing costs associated with Group debt facilities.

Corporate and other normalised results	31 Dec 2019 $m	31 Dec 2018 $m	Change $m	Change %
Net income	0.2	0.5	(0.3)	(60.0)
Operating expenses	(32.8)	(31.6)	(1.2)	3.8
Normalised EBIT	(32.6)	(31.1)	(1.5)	4.8
Interest and borrowing costs	(2.5)	(2.9)	0.4	(13.8)
Normalised loss before tax	(35.1)	(34.0)	(1.1)	3.2

Normalised EBIT for the Corporate and other segment was lower (down $1.5 million) as a result of higher operating expenses.

12 Outlook for the 2020 financial year

Challenger is well positioned with strong product offerings, positive retirement market demographics and highly efficient operations. It is, however, facing some current challenges from financial advice market disruption.

For 2020, Challenger is targeting normalised net profit before tax of between $500 million and $550 million. This profit range reflects the lower normalised growth assumption for Equity and other investments ($23.0 million), increased expenditure in Distribution, Product and Marketing to support growth initiatives (up to $15.0 million) and lower interest rates reducing the return on shareholder capital. Following the interim result Challenger expects to be around the top end of the guidance range.

The normalised cost to income ratio is forecast to be above the medium term range of 30–34% as a result of the increased spend to support growth initiatives in Distribution, Product and Marketing.

Challenger is targeting a normalised RoE of RBA cash rate plus 14% (pre-tax). Reflecting the resilience and capital strength of the business, the Board expects to maintain the same annual dividend of 35.5 cents per share in the 2020[2] financial year. This will result in the normalised dividend payout ratio being above the target payout ratio of 45 – 50% of normalised profit.

[1] Consolidated FUM for Australian Fund Managers – Rainmaker Roundup, March 2019.

[2] Subject to market conditions and capital allocation priorities.

Directors' report

1 Directors

The names and details of the Directors of Challenger Limited holding office during the six months to 31 December 2019 and as at the date of this report are listed below. Directors were in office for this entire period unless otherwise stated.

Directors	
Peter Polson	Independent Chair
Richard Howes	Managing Director and Chief Executive Officer
John M Green	Independent Non-Executive Director
Steven Gregg	Independent Non-Executive Director
Masahiko Kobayashi[1] (appointed 26 August 2019)	Non-Independent Non-Executive Director
JoAnne Stephenson	Independent Non-Executive Director
Duncan West	Independent Non-Executive Director
Melanie Willis	Independent Non-Executive Director
Leon Zwier (retired 31 October 2019)	Independent Non-Executive Director

[1] Hiroyuki Iioka was appointed as an alternate director to Masahiko Kobayashi on 13 December 2019.

The information appearing on pages 1 to 15 forms part of the Directors' report for the six months to 31 December 2019 and is to be read in conjunction with the following information.

2 Significant events after the balance date

At the date of this financial report, no matter or circumstance has arisen that has affected, or may significantly affect, the Group's operations, the results of those operations or the Group's state of affairs in future financial years which has not already been reflected in this report.

3 Rounding

The amounts contained in this report and the financial report have been rounded to the nearest $100,000 unless otherwise stated, under the option available to the Group under Australian Securities and Investments Commission (ASIC) Corporations Instrument 2016/191.

4 Authorisation

Signed in accordance with a resolution of the Directors of Challenger Limited:

P Polson
Independent Chair

Sydney
10 February 2020

R Howes
Managing Director & Chief Executive Officer

Sydney
10 February 2020

5 Auditor's independence declaration

The Directors received the following declaration from the auditor of Challenger Limited:

Building a better working world

Ernst & Young
200 George Street
Sydney NSW 2000 Australia
GPO Box 2646 Sydney NSW 2001

Tel: +61 2 9248 5555
Fax: +61 2 9248 5959
ey.com/au

Auditor's independence declaration to the Directors of Challenger Limited

As lead auditor for the review of the half-year financial report of Challenger Limited for the half-year ended 31 December 2019, I declare to the best of my knowledge and belief, there have been:

a) no contraventions of the auditor independence requirements of the *Corporations Act 2001* in relation to the review; and

b) no contraventions of any applicable code of professional conduct in relation to the review.

This declaration is in respect of Challenger Limited and the entities it controlled during the financial period.

Ernst & Young

T Johnson
Partner

Sydney
10 February 2020

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Financial statements

This financial report covers Challenger Limited (the Company) and its controlled entities (the Group or Challenger).

Statement of comprehensive income

For the six months ended 31 December	Note	2019 $m	2018 $m
Revenue	1	1,222.2	893.5
Expenses	2	(803.5)	(784.9)
Finance costs[1]		(109.6)	(125.3)
Share of profits of associates		12.8	11.7
Profit/(loss) before income tax		**321.9**	**(5.0)**
Income tax (expense)/benefit	4	(99.7)	11.2
Profit for the period after income tax		**222.2**	**6.2**
Profit attributable to shareholders of Challenger Limited		220.4	6.1
Profit attributable to non-controlling interests		1.8	0.1
Profit for the period after income tax		**222.2**	**6.2**
Other comprehensive income			
Items that may be reclassified to profit and loss, net of tax			
Translation of foreign entities		(4.6)	26.8
Hedge of net investment in foreign entities		2.7	(24.0)
Cash flow hedges – SPV[2]		(0.1)	0.2
Other comprehensive income for the year		(2.0)	3.0
Total comprehensive income for the period after tax		**220.2**	**9.2**
Comprehensive income attributable to shareholders of Challenger Limited		218.4	9.1
Comprehensive income attributable to non-controlling interests		1.8	0.1
Total comprehensive income for the period after tax		**220.2**	**9.2**
Earnings per share attributable to ordinary shareholders of Challenger Limited		Cents	Cents
Basic	12	36.3	1.0
Diluted	12	31.5	1.0

[1] Includes interest expense on lease liability ($1.5 million).
[2] SPV = Special Purpose Vehicles.

The statement of comprehensive income should be read in conjunction with the accompanying notes.

Statement of financial position

As at	Note	31 Dec 2019 $m	30 Jun 2019 $m	31 Dec 2018 $m
Assets				
Cash and cash equivalents		760.2	725.4	475.6
Cash and cash equivalents – SPV		65.0	66.5	74.1
Receivables		306.5	580.0	618.5
Current tax assets		-	2.7	50.7
Derivative assets		819.9	762.5	429.3
Financial assets – fair value through profit and loss	5	20,813.9	19,929.6	18,786.8
Investment property held for sale	6	-	166.5	279.6
Investment and development property	6	3,703.6	3,562.7	3,812.3
Mortgage assets – SPV		776.2	860.6	945.3
Finance leases		30.3	49.5	53.1
Property, plant and equipment		27.5	28.6	221.3
Investment in associates		56.1	58.1	53.4
Other assets		60.3	76.6	57.1
Right-of-use lease assets[1]		34.4	-	-
Goodwill		580.3	557.3	571.6
Deferred tax assets		5.6	7.0	7.9
Other intangible assets		21.7	23.9	23.3
Total assets of shareholders of Challenger Limited and non-controlling interests		**28,061.5**	**27,457.5**	**26,459.9**
Liabilities				
Payables		1,022.5	1,168.2	792.1
Current tax liability		28.5	-	-
Derivative liabilities		468.1	569.2	533.5
Interest bearing financial liabilities	10	6,301.4	6,313.1	6,267.5
Interest bearing financial liabilities – SPV		677.2	763.4	855.3
External unit holders' liabilities		2,705.6	1,966.2	2,172.3
Provisions		17.0	19.2	22.1
Lease liabilities[1]		70.2	-	-
Deferred tax liabilities		181.9	165.2	90.3
Life contract liabilities	7	12,845.3	12,870.2	12,323.7
Total liabilities of shareholders of Challenger Limited and non-controlling interests		**24,317.7**	**23,834.7**	**23,056.8**
Net assets of shareholders of Challenger Limited and non-controlling interests		**3,743.8**	**3,622.8**	**3,403.1**
Equity				
Contributed equity	9	2,110.8	2,093.7	2,090.2
Reserves		(61.0)	(52.4)	(66.0)
Retained earnings		1,666.0	1,559.0	1,363.7
Total equity of shareholders of Challenger Limited		**3,715.8**	**3,600.3**	**3,387.9**
Non-controlling interests		28.0	22.5	15.2
Total equity of shareholders of Challenger Limited and non-controlling interests		**3,743.8**	**3,622.8**	**3,403.1**

[1] Reflects the adoption of AASB 16 on 1 July 2019. As permitted by the standard, the Group has not restated the comparative financial reporting periods.

The statement of financial position should be read in conjunction with the accompanying notes.

Statement of changes in equity

		Attributable to shareholders of Challenger Limited								
For the period ended 31 December 2018	Note	Contributed equity $m	Share-based payment reserve $m	Cash flow hedge reserve – SPV $m	Foreign currency translation reserve $m	Adjusted controlling interest reserve $m	Retained earnings $m	Total shareholder equity $m	Non-controlling interests $m	Total equity $m
Balance at 1 July 2018		2,051.7	(43.0)	0.3	(3.3)	12.7	1,467.0	3,485.4	0.4	3,485.8
Profit for the year		-	-	-	-	-	6.1	6.1	0.1	6.2
Other comprehensive income for the year		-	-	0.2	2.8	-	-	3.0	-	3.0
Total comprehensive income for the year		**-**	**-**	**0.2**	**2.8**	**-**	**6.1**	**9.1**	**0.1**	**9.2**
Other equity movements										
Ordinary shares issued	9	3.4	-	-	-	-	-	3.4	-	3.4
Treasury shares purchased	9	(32.8)	-	-	-	-	-	(32.8)	-	(32.8)
Treasury shares vested	9	42.6	-	-	-	-	-	42.6	-	42.6
Deferred Treasury share purchases	9	(7.5)	-	-	-	-	-	(7.5)	-	(7.5)
Settled forward purchases of Treasury shares	9	32.8	-	-	-	-	-	32.8	-	32.8
Share-based payment expense net of tax less releases		-	(29.5)	-	-	-	-	(29.5)	-	(29.5)
Dividends paid	11	-	-	-	-	-	(109.4)	(109.4)	-	(109.4)
Other movements		-	-	-	-	(6.2)	-	(6.2)	14.7	8.5
Balance at 31 December 2018		**2,090.2**	**(72.5)**	**0.5**	**(0.5)**	**6.5**	**1,363.7**	**3,387.9**	**15.2**	**3,403.1**
For the period ended 31 December 2019										
Balance at 1 July 2019		2,093.7	(57.7)	0.1	(2.6)	7.8	1,559.0	3,600.3	22.5	3,622.8
Transition of new leasing standard net of tax							(3.7)	(3.7)	-	(3.7)
Restated balance at 1 July 2019		**2,093.7**	**(57.7)**	**0.1**	**(2.6)**	**7.8**	**1,555.3**	**3,596.6**	**22.5**	**3,619.1**
Profit for the year		-	-	-	-	-	220.4	220.4	1.8	222.2
Other comprehensive income for the year		-	-	(0.1)	(1.9)	-	-	(2.0)	-	(2.0)
Total comprehensive income for the year		**-**	**-**	**(0.1)**	**(1.9)**	**-**	**220.4**	**218.4**	**1.8**	**220.2**
Other equity movements										
Ordinary shares issued	9	2.6	-	-	-	-	-	2.6	-	2.6
Treasury shares purchased	9	(8.8)	-	-	-	-	-	(8.8)	-	(8.8)
Treasury shares vested	9	14.5	-	-	-	-	-	14.5	-	14.5
Deferred Treasury share purchases	9	-	-	-	-	-	-	-	-	-
Settled forward purchases of Treasury shares	9	8.8	-	-	-	-	-	8.8	-	8.8
Share-based payment expense net of tax less releases		-	(7.2)	-	-	-	-	(7.2)	-	(7.2)
Dividends paid	11	-	-	-	-	-	(109.7)	(109.7)	-	(109.7)
Other movements		-	-	-	-	0.6	-	0.6	3.7	4.3
Balance at 31 December 2019		**2,110.8**	**(64.9)**	**-**	**(4.5)**	**8.4**	**1,666.0**	**3,715.8**	**28.0**	**3,743.8**

The statement of changes in equity should be read in conjunction with the accompanying notes.

Statement of cash flows

For the six months ended 31 December	Note	2019 $m	2018 $m
Operating activities			
Receipts from customers		316.5	332.7
Annuity and premium receipts	7	1,968.6	2,150.1
Annuity and claim payments	7	(2,054.4)	(1,839.1)
Payments to reinsurer	7	-	(5.9)
Receipts from external unit holders		1,182.2	599.7
Payments to external unit holders		(486.7)	(599.7)
Payments to vendors and employees		(316.2)	(332.4)
Dividends received		45.7	67.3
Interest received		396.0	403.5
Interest paid		(61.8)	(78.1)
Income tax paid		(48.9)	(43.6)
Net cash inflows from operating activities	8	**941.0**	**654.5**
Investing activities			
Payments on net purchases of investments		(766.3)	(1,202.9)
Net payments for purchase of controlled entities		(10.2)	-
Net mortgage loan repayments		77.6	82.3
Payments for net purchases of property, plant and equipment		(6.0)	(41.4)
Payments for purchase of associate interest		-	(2.8)
Net cash outflows from investing activities		**(704.9)**	**(1,164.8)**
Financing activities			
Proceeds from issue of ordinary shares	9	2.6	3.4
Net proceeds from borrowings – interest bearing financial liabilities	10	(89.3)	366.7
Payments for lease liabilities[1]		(2.6)	-
Payments for Treasury shares		(3.8)	(39.7)
Net dividends paid	11	(109.7)	(109.4)
Net cash (outflows)/inflows from financing activities		**(202.8)**	**221.0**
Net increase/(decrease) in cash and cash equivalents		**33.3**	**(289.3)**
Cash and cash equivalents at the beginning of the period		791.9	839.0
Cash and cash equivalents at the end of the period		**825.2**	**549.7**

[1] Reflects the adoption of AASB 16 on 1 July 2019. As permitted by the standard, the Group has not restated the comparative financial reporting period.

The statement of cash flows should be read in conjunction with the accompanying notes.

Basis of preparation and overarching significant accounting policies

Challenger Limited (the Company or the parent entity) is a company limited by shares, incorporated and domiciled in Australia, whose shares are publicly traded on the Australian Securities Exchange (ASX).

The interim financial report for Challenger Limited and its controlled entities (the Group or Challenger) for the six months ended 31 December 2019 was authorised for issue in accordance with a resolution of the Directors of the Company on 10 February 2020.

(i) Basis of preparation and statement of compliance

This is a general purpose interim financial report for the six months ended 31 December 2019 that has been prepared in accordance, and complies, with the requirements of the *Corporations Act 2001* and AASB 134 *Interim Financial Reporting.* Challenger Limited is a for-profit entity for the purposes of preparing financial statements.

The interim financial report does not include all the notes normally included in an annual financial report. It is recommended that this interim financial report be read in conjunction with the financial report for the year ended 30 June 2019 and any public announcements made by the Group in accordance with the continuous disclosure obligations of the ASX listing rules.

Unless otherwise stated, amounts in this financial report are presented in Australian dollars and have been prepared on a historical cost basis. The assets and liabilities disclosed in the statement of financial position are grouped by nature and listed in an order that reflects their relative liquidity.

(ii) New and revised accounting standards and interpretations

Except for the matters referred to below, the accounting policies applied in these interim financial statements are the same as those applied in the Group's financial statements as at and for the year ended 30 June 2019.

New accounting standards and amendments that are effective in the current financial year

The following new accounting standards have been applied from 1 July 2019.

AASB 16 *Leases*

AASB 16 *Leases* amends the accounting standard for leases and replaces AASB 117 *Leases*. The standard removes the distinction between operating and finance leases and requires lessees to bring all leases on to the statement of financial position.

The effect of adopting AASB 16 as at 1 July 2019 (increase/(decrease)) is as follows[1]:

	1 July 2019 $m
Assets	
Right-of-use lease asset	36.7
Deferred tax asset	1.6
Total assets	**38.3**
Liabilities	
Lease liabilities	72.9
Total liabilities	**72.9**
Total adjustment on equity of shareholders	**(3.7)**
Retained earnings	**(3.7)**

[1] Existing balances under AASB 117 Leases were utilised to derive the take on position as at 1 July 2019.

This mainly relates to the lease obligations of 5 Martin Place, Sydney, which is Challenger's principal place of business. Lessor accounting remains largely unchanged.

Prior to the adoption of AASB 16, the Group classified each of its leases (where acting as a lessee) at the inception date as either a finance lease or an operating lease. A lease was classified as a finance lease if it transferred substantially all of the risks and rewards incidental to ownership of the leased asset to the Group; otherwise it was classified as an operating lease.

Finance leases were capitalised at the commencement of the lease at the inception date fair value of the leased property or, if lower, at the present value of the minimum lease payments. Lease payments were then apportioned between interest (recognised as finance costs) and reduction of the lease liability.

In an operating lease, the leased property was not capitalised and the lease payments were recognised as a rent expense in the statement of comprehensive income on a straight-line basis over the lease term. Any prepaid rent or accrual was recognised under other assets or payables.

Upon adoption of AASB 16, the Group applied a single recognition and measurement approach for all leases, except for short term leases and leases of low-value assets.

Finance leases

There was no material impact to the Group for leases classified as finance leases where the Group acted as a lessee.

Operating leases

The Group adopted AASB 16 using the modified retrospective method of adoption effective from 1 July 2019. Under this method, the standard is applied retrospectively with the cumulative effect of initially applying the standard recognised at the date of initial application. The Group elected to use the 'transition practical expedient' method, allowing the standard to be applied only to contracts that were previously identified as leases under AASB 117 *Leases* and Interpretation 4 *Determining whether an Arrangement Contains a Lease* at the date of initial application.

Basis of preparation and overarching significant accounting policies (continued)

(ii) New and revised accounting standards and interpretations (continued)

The Group also elected to use the recognition exemptions for lease contracts that, at the commencement date, have a lease term of 12 months or less and do not contain a purchase option ('short-term leases'), and lease contracts for which the underlying asset is of low value ('low-value assets').

The right-of-use lease asset for 5 Martin Place was recognised based on the carrying amount as if the standard had always been applied, apart from the use of incremental borrowing rate at the date of initial application. For other leases, the right-of-use lease assets were recognised based on the amount equal to the lease liabilities, adjusted for any related prepaid and accrued lease payments previously recognised.

The adoption of the modified retrospective method avoids any restatement of prior year comparative information, including profit and loss and cash flow reporting.

New accounting policies of the Group upon adoption of AASB 16

Right-of-use lease assets

The Group recognises right-of-use assets at the commencement date of the lease (i.e. the date the underlying asset is available for use). Right-of-use assets are measured at cost, less any accumulated depreciation and impairment losses, and less any adjustments for any remeasurement of lease liabilities. The cost of right-of-use assets includes the amount of lease liabilities recognised, initial direct costs incurred, and lease payments made at or before the commencement date less any lease incentives received. Unless the Group is reasonably certain to obtain ownership of the leased assets at the end of the lease term, the recognised right-of-use assets are depreciated on a straight line basis over the shorter of its estimated useful life and the lease term. Right-of-use assets are subject to impairment.

Lease liabilities

At the commencement date of the lease, the Group recognises lease liabilities measured at the present value of lease payments to be made over the lease term. The lease payments include fixed payments (including in-substance fixed payments), less any lease incentives receivable, variable lease payments that depend on an index or a rate, and amounts expected to be paid under residual value guarantees. The lease payments include the exercise price of a purchase option reasonably certain to be exercised by the Group and payments of penalties for terminating a lease, if the lease term reflects the Group exercising the option to terminate. The variable lease payments that do not depend on an index or a rate are recognised as an expense in the period in which the event or condition that triggers the payment occurs. In calculating the present value of lease payments, the Group uses the incremental borrowing rate at the lease commencement date if the interest rate implicit in the lease is not readily determinable. After the commencement date, the amount of lease liabilities is increased to reflect the accretion of interest and reduced for the lease payments made. In addition, the carrying amount of lease liabilities is remeasured if there is a modification, a change in the lease term, a change in the in-substance fixed lease payments or a change in the assessment to purchase the underlying asset.

Significant judgement in determining the lease term of contracts with renewal

The Group determines the lease term as the non-cancellable term of the lease, together with any periods covered by an option to extend the lease if it is reasonably certain to be exercised, or any periods covered by an option to terminate the lease, if it is reasonably certain not to be exercised.

The Group has the option, under some of its leases to lease the assets for additional terms. The Group applies judgement in evaluating whether it is reasonably certain to exercise the option to renew. That is, it considers all relevant factors that create an economic incentive for it to exercise the renewal. After the commencement date, the Group reassesses the lease term if there is a significant event or change in circumstances that is within its control and affects its ability to exercise (or not exercise) the option to renew.

AASB Interpretation 23 *Uncertainty over Income Tax Treatments*

The Interpretation addresses the accounting for income taxes when tax treatments involve uncertainty that affects the application of AASB 112 *Income Taxes* and does not apply to taxes or levies outside the scope of AASB 112, nor does it specifically include requirements relating to interest and penalties associated with uncertain tax treatments. The Interpretation specifically addresses the following:

- whether an entity considers uncertain tax treatments separately;
- the assumptions an entity makes about the examination of tax treatments by taxation authorities;
- how an entity determines taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates; and
- how an entity considers changes in facts and circumstances.

An entity is required to determine whether to consider each uncertain tax treatment separately or together with one or more other uncertain tax treatments. The approach that better predicts the resolution of the uncertainty should be followed. The Interpretation is effective for annual reporting periods beginning on or after 1 July 2019. The Interpretation did not have a material impact on the consolidated financial statements of the Group.

Accounting standards and interpretations issued but not yet effective

AASB 17 *Insurance Contracts*

AASB 17 *Insurance Contracts* replaces AASB 4 *Insurance Contracts*, AASB 1038 *Life Insurance Contracts* and AASB 1023 *General Insurance Contracts* and is effective for Challenger from 1 July 2021. AASB 17 *Insurance Contracts* establishes globally consistent principles for the recognition, measurement, presentation and disclosure of life insurance contracts issued. Life investment contracts are currently measured under the financial instruments standard and are expected to continue to be recognised under this standard.

Basis of preparation and overarching significant accounting policies (continued)

(ii) New and revised accounting standards and interpretations (continued)

AASB 17 introduces changes to the profit emergence profiles of life insurance contracts but does not affect the underlying economics or cash flows of the contracts. The impacts on capital requirements and income tax are unknown, pending regulatory responses from APRA and the Australian Taxation Office (ATO) respectively.

The main changes anticipated for the Group under AASB 17 are set out below:

- insurance contract portfolios will be disaggregated to more granular levels and will be required to be evaluated by risk type, issue year and profitability;
- although conceptually similar, the Contractual Service Margin recognises profit on a different basis to the current Margin on Services approach and therefore the profit signature is likely to change for portfolios with positive profit margins;
- a new risk adjustment for non-financial risk will be introduced which reflects the compensation that the Group requires for bearing the uncertainty in relation to the amount and timing of cash flows. The confidence level used to determine the risk adjustment will need to be disclosed;
- additional disclosures will be more extensive, requiring increased granularity and more analysis of movements.

In June 2019, the International Accounting Standards Board (IASB) issued an exposure draft proposing several amendments to the standard and to defer the effective date by one year. The IASB expects to publish any approved amendments to IFRS 17 in mid-2020. The amendments are expected to apply to AASB 17.

The Group has conducted a business impact assessment and key recommendations will be implemented ahead of the standard being introduced.

While the standard is expected to impact the Group's profit and loss, it is not yet practicable to determine the quantum.

Existing standards and interpretations not yet effective

Other amendments to existing standards or interpretations that are not yet effective are not expected to result in a material impact to the Group's financial statements.

Note 1 Revenue

	31 Dec 2019 $m	31 Dec 2018 $m
Investment revenue		
Fixed income securities and cash[1]	372.8	529.4
Investment property and property securities	163.0	207.7
Equity and infrastructure investments	85.9	(16.4)
Realised and unrealised gains/(losses) on hedges and foreign exchange translation	32.9	(178.0)
Management fee revenue	110.0	115.9
Other revenue		
Life insurance contract premiums and related revenue[2]	457.6	234.9
Total revenue	**1,222.2**	**893.5**

[1] Includes fair value and realised movements in subordinated debt and includes interest revenue of $404.7 million, $381.6 million was calculated using the effective interest rate method.

[2] Changes in life insurance and investment contract liabilities arising from new business, annuity payments, discount rates, inflation rates and other assumptions are recognised as revenue, with other movements being included in Note 2 Expenses.

Note 2 Expenses

	31 Dec 2019 $m	31 Dec 2018 $m
Life insurance contract claims and expenses[1]	518.5	525.2
Investment property related expenses[2]	46.1	57.9
Fee expense	62.4	53.3
Distribution expenses	22.8	24.5
Employee benefits expenses	92.4	93.0
Other expenses[3]	61.3	31.0
Total expenses	**803.5**	**784.9**

[1] Cost of life contract liabilities recognised as an expense consists of the interest expense on the liability and any loss on the initial recognition of new business less the release of liability in respect of expenses incurred in the current period. The interest expense on the liability represents the unwind of the discount on the opening liability over the period, whereas the impacts of changes in the discount rate applied for the current valuation are included in the change in life contract liabilities disclosed in Note 1 Revenue.

[2] Investment property-related expenses relate to rental income generating investment properties.

[3] Includes depreciation of right-of-use lease asset ($2.3 million) and impairments ($8.9 million).

Note 3 Segment information

The reporting segments[1] of the Group have been identified as follows:

	Life		Funds Management		Total reporting segments		Corporate and other[2]		Total	
For the six months ended 31 December	2019 $m	2018 $m	2019 $m	2018 $m	2019 $m	2018 $m	2019 $m	2018 $m	2019 $m	2018 $m
Net income	344.8	329.6	77.7	75.2	422.5	404.8	0.2	0.5	422.7	405.3
Operating expenses	(59.0)	(51.7)	(49.8)	(49.1)	(108.8)	(100.8)	(32.8)	(31.6)	(141.6)	(132.4)
Normalised EBIT	**285.8**	**277.9**	**27.9**	**26.1**	**313.7**	**304.0**	**(32.6)**	**(31.1)**	**281.1**	**272.9**
Interest and borrowing costs		-		-		-	(2.5)	(2.9)	(2.5)	(2.9)
Normalised net profit/(loss) before tax	**285.8**	**277.9**	**27.9**	**26.1**	**313.7**	**304.0**	**(35.1)**	**(34.0)**	**278.6**	**270.0**
Tax on normalised profit									(87.2)	(70.2)
Normalised net profit after tax									**191.4**	**199.8**
Investment experience after tax									38.4	(193.7)
Significant items after tax									(9.4)	-
Profit attributable to the shareholders of Challenger Ltd									**220.4**	**6.1**
Other statutory segment information										
Revenue from external customers[3]	721.0	372.2	96.5	88.6	817.5	460.8	-	-	817.5	460.8
Interest revenue	403.5	427.6	-	-	403.5	427.6	1.2	5.1	404.7	432.7
Interest expense	(89.3)	(103.7)	-	(0.1)	(89.3)	(103.8)	(20.3)	(21.5)	(109.6)	(125.3)
Intersegment revenue	(23.3)	(21.8)	23.3	21.8	-	-	-	-	-	-
Depreciation and amortisation	-	(3.0)	(0.3)	(0.3)	(0.3)	(3.3)	(5.2)	(4.2)	(5.5)	(7.5)
As at 31 December										
Segment assets	20,585.3	19,185.2	263.3	248.6	20,848.6	19,433.8	7,184.9	7,010.9	28,033.5	26,444.7
Segment liabilities	(17,111.4)	(16,114.6)	(26.7)	(25.8)	(17,138.1)	(16,140.4)	(7,179.6)	(6,916.4)	(24,317.7)	(23,056.8)
Net assets attributable to shareholders	**3,473.9**	**3,070.6**	**236.6**	**222.8**	**3,710.5**	**3,293.4**	**5.3**	**94.5**	**3,715.8**	**3,387.9**

[1] Refer below for definitions of the terms used in the management view of segments.
[2] Corporate and other includes corporate companies, corporate SPV, non-controlling interests and Group eliminations.
[3] Funds management revenue from external customers is predominantly management fees.

Definitions

Operating segments

The following segments are identified on the basis of internal reporting to key management personnel, including the Chief Executive Officer (the chief operating decision maker) of the Group, and comprise component parts of the Group that are regularly reviewed by senior management in order to allocate resources and assess performance:

Life

The Life segment principally includes the annuity and life insurance business carried out by CLC and Accurium Pty Limited (provision of self-managed superannuation fund actuarial certificates). CLC offers fixed rate retirement and superannuation products that are designed for Australian investors who are seeking a low risk fixed term or lifetime investment and reliable income. CLC also offers fixed term and lifetime investments to investors in Japan through its reinsurance arrangement with MSP. CLC invests in assets providing long-term income streams for customers.

Funds Management

Funds Management earns fees from its Fidante Partners and Challenger Investment Partners operations, providing an end-to-end funds management business. Funds Management has equity investments in a number of Fidante Partners boutique fund managers and, through the Challenger Investment Partners business, offers a range of managed investments across fixed income and property.

Note 3 Segment information (continued)

Definitions (continued)

Corporate and other

The corporate segment, which is not considered an operating segment of the Group, is used to reconcile the total segment results back to the consolidated results and consists of other income and costs that fall outside the day-to-day operations of the reportable segments. These include the costs of the Group CEO and CFO, shared services across the Group, long-term incentive costs, Directors' fees, corporate borrowings and associated borrowing costs and shareholder registry services.

To reconcile to Group results, the Corporate and other segment also includes eliminations and non-core activities of the Group.

Transactions between segments

All transactions and transfers between segments are generally determined on an arm's length basis and are included within the relevant categories of income and expense. These transactions eliminate on consolidation.

Normalised vs. statutory results

Net income and operating expenses differ from revenue and expenses as disclosed in the statement of comprehensive income as certain direct costs (including distribution expenses, property expenses and management fees) included in expenses are netted off against revenues in deriving the aforementioned management view of net income. Net income consists of the following sub-categories of management views of revenue:

- Normalised cash operating earnings (Life segment);
- Net income (Funds Management segment); and
- Other income (Corporate and other segment).

In addition, the revenues, expenses and finance costs from Special Purpose Vehicles (SPV) are separately disclosed in the statutory view but are netted off in net income in the management view of the Life segment.

Revenue also includes investment gains and losses which are excluded from the management view as they form part of investment experience (refer below).

Normalised cash operating earnings

This is calculated as cash earnings plus normalised capital growth (refer below). Cash earnings represent the sum of investment yield (being the management view of revenue from investment assets such as net rental income, dividends and interest), interest expense, distribution expenses and fees.

Normalised EBIT

Normalised earnings before interest and tax (EBIT) comprises net income less operating expenses, as defined above. It excludes investment experience, corporate interest and borrowing costs, tax and any significant items (refer below).

Interest and borrowing costs differ from finance costs as disclosed in the statement of comprehensive income for similar reasons to revenue and expenses, with the major difference arising from the netting of SPV finance costs against SPV revenue in net income in the management view of the Life segment.

Tax on normalised profit

This represents the consolidated statutory tax expense or benefit for the period, less tax attributable to non-controlling interests, investment experience and significant items.

Investment experience after tax

The Group is required by accounting standards to value applicable assets and liabilities supporting the life insurance business at fair value. This can give rise to fluctuating valuation movements being recognised in the statement of comprehensive income, particularly during periods of market volatility. As the Group is generally a long-term holder of assets, due to assets being held to match the term of life contract liabilities, the Group takes a long-term view of the expected capital growth of the portfolio rather than focusing on short-term volatility. Investment experience is a mechanism employed to isolate the volatility arising from asset and liability valuation within the results so as to more accurately reflect the underlying performance of the Group.

Investment experience is calculated as the difference between the actual investment gains/losses (both realised and unrealised) and the normalised capital growth (refer below) plus life contract valuation changes and new business strain. Investment experience after tax is investment experience net of tax at the prevailing income tax rate.

Normalised capital growth

This is determined by multiplying the normalised capital growth rate for each asset class by the average investment assets for the period. The normalised growth rates represent the Group's medium to long-term capital growth expectations for each asset class over the investment cycle.

The annual normalised growth rates are +3.5% for equity and other investments (+4.5% for the prior period), +4.0% for infrastructure, +2.0% for property and -0.35% for cash and fixed income. Except where stated, these are consistent with the rates applied in the prior period. The rates have been set with reference to medium to long-term market growth rates and are reviewed to ensure consistency with prevailing market conditions.

Life contract valuation assumption changes represent the impact of changes in macroeconomic variables including bond yields and inflation factors, expense assumptions and other factors applied in the valuation of life contract liabilities. It also includes the attribution of the corresponding interest rate, foreign exchange and inflation derivatives used for hedging.

New business strain is a non-cash valuation adjustment recognised when annuity rates on new business are higher than the risk-free rate used to fair value life contracts. Maintenance expense allowances over the expected future term of the new business are also included in the life contract valuation. New business strain reported in the period represents the valuation loss on new sales generated in the current period net of the reversal of new business strain of prior period sales.

Note 3 Segment information (continued)

Significant items after tax

The Group presents additional non-IFRS financial information to the market to provide meaningful insights into the financial condition of the business. Due consideration has been given to ensure that disclosure of Challenger's normalised profit framework is explained, reconciled and calculated consistently period-on-period. Within this framework, Challenger defines significant items as non-recurring or abnormal income or expense items. For the period ended 31 December 2019, significant items were negative $9.4 million (after tax). They include the impairment of an intangible asset recognised in relation to the revenue share interest owned in respect of Latigo Investment Partners ($6.6 million), and a boutique impairment charge and wind-up costs following the closure of FME Asset Management ($2.8 million).

Major customers

No individual customer amounted to greater than 10% of the Group's revenue.

Geographical areas

The Group operates predominantly in Australia, thus no geographical split is provided to the chief operating decision maker.

	31 Dec 2019 $m	31 Dec 2018 $m
Reconciliation of management to statutory view of after-tax profit		
Operating segments normalised net profit before tax	313.7	304.0
Corporate and other normalised net loss before tax	(35.1)	(34.0)
Normalised net profit before tax (management view of pre-tax profit)	**278.6**	**270.0**
Tax on normalised profit	(87.2)	(70.2)
Normalised net profit after tax	**191.4**	**199.8**
Investment experience after tax	38.4	(193.7)
Significant items after tax	(9.4)	-
Profit attributable to the shareholders of Challenger Limited	**220.4**	**6.1**
Profit attributable to non-controlling interests excluded from management view	1.8	0.1
Statutory view of profit after tax	**222.2**	**6.2**
Reconciliation of management view of revenue to statutory revenue		
Operating segments	422.5	404.8
Corporate and other	0.2	0.5
Net income (management view of revenue)	**422.7**	**405.3**
Expenses and finance costs offset against revenue		
SPV expenses and finance costs offset against SPV income	6.7	12.6
Distribution expenses offset against related income	22.8	24.5
Change in life contract liabilities and reinsurance contracts recognised in expenses	518.5	525.2
Property related expenses offset against property income	46.1	57.8
Interest and loan amortisation costs	82.5	91.1
Management fee expenses	62.4	53.3
Adjustment for non-controlling interests and other items	4.6	(6.1)
Difference between management view of investment experience and statutory recognition		
Actual capital growth	111.2	(134.6)
Normalised capital growth	(70.6)	(78.1)
Life contract valuation experience	14.3	(21.6)
New business strain	1.0	(35.9)
Statutory revenue (refer Note 1 Revenue)	**1,222.2**	**893.5**

Note 4 Income tax

Reconciliation of income tax (expense)/benefit	31 Dec 2019 $m	31 Dec 2018 $m
Profit/(Loss) before income tax	321.9	(5.0)
Prima facie income tax based on the Australian company tax rate of 30%	(96.6)	1.5
Tax effect of amounts not assessable/deductible in calculating taxable income:		
– Challenger Capital Notes distributions	(4.3)	(5.0)
– non-assessable and non-deductible items	4.3	14.9
– other items	(3.1)	(0.2)
Income tax (expense)/benefit	**(99.7)**	**11.2**
Underlying effective tax rate[1]	**31.1%**	**219.6%**

[1] The calculation of the underlying effective tax rate excludes the non-controlling interests' profit of $1.8 million (31 December 2018: $0.1 million).

Analysis of income tax (expense)/benefit	31 Dec 2019 $m	31 Dec 2018 $m
Current income tax expense for the period	(86.8)	(5.6)
Current income tax benefit prior period adjustment	3.8	5.4
Deferred income tax (expense)/benefit	(13.8)	13.6
Deferred income tax expense prior period adjustment	(2.9)	(2.2)
Income tax (expense)/benefit	**(99.7)**	**11.2**
Income tax benefit/(expense) on translation of foreign entities	1.7	(10.8)
Income tax (expense)/benefit on hedge of net investment in foreign entities	(1.1)	10.3
Income tax benefit/(expense) from other comprehensive income	**0.6**	**(0.5)**

Recognised deferred tax balances	31 Dec 2019 $m	30 Jun 2019 $m
Tax consolidated group losses	1.6	-
Non-tax consolidated group losses	10.1	11.3
DTA on losses	**11.7**	**11.3**

Unrecognised deferred tax balances	31 Dec 2019 $m	30 Jun 2019 $m
Non-tax consolidated group revenue losses – tax effected	6.4	2.9
Tax consolidated group capital losses – tax effected	56.2	54.8

Note 5 Financial assets – fair value through profit and loss

	31 Dec 2019 $M	30 June 2019 $m	31 Dec 2018 $m
Domestic sovereign bonds and semi-government bonds	7,046.3	5,486.8	6,807.8
Floating rate notes and corporate bonds	5,854.1	7,798.5	5,577.5
Residential mortgage and asset-backed securities	5,223.4	4,044.4	3,889.2
Non-SPV mortgage assets	281.4	272.8	264.7
Fixed income securities	18,405.2	17,602.5	16,539.2
Shares in listed and unlisted corporations	117.8	96.1	105.7
Unit trusts, managed funds and other	1,351.2	1,236.1	1,236.7
Equity securities	1,469.0	1,332.2	1,342.4
Units in listed and unlisted infrastructure trusts	520.2	542.5	465.7
Other infrastructure investments	319.8	324.6	306.8
Infrastructure investments	840.0	867.1	772.5
Indirect property investments in listed and unlisted trusts	99.7	127.8	132.7
Property securities	99.7	127.8	132.7
Total financial assets – fair value through profit and loss	20,813.9	19,929.6	18,786.8

Note 6 Investment and development property

	31 Dec 2019 $m	30 June 2019 $m	31 Dec 2018 $m
Investment property held for sale[1]	-	166.5	279.6
Investment property in use	3,698.9	3,384.3	3,426.9
Investment property under development	4.7	178.4	384.7
Total investment property	3,703.6	3,729.2	4,091.2
Development property held for resale[2]	-	-	0.7
Total investment and development property[3]	3,703.6	3,729.2	4,091.9

[1] Held for sale properties: no properties held for sale at 31 December 2019.
[2] Development property held for resale is held at the lower of cost or net realisable value.
[3] Investment property held for sale and development property held for resale are considered current. All other investment property is considered non-current.

Note 7 Life contract liabilities

Fair value of life contract liabilities	31 Dec 2019 $m	30 June 2019 $m	31 Dec 2018 $m
Life investment contract liabilities – at fair value	6,428.9	6,757.7	6,750.1
Life insurance contract liabilities – at margin on services value	6,417.1	6,113.1	5,501.4
Reinsurance contract liabilities – at margin on services value	(0.7)	(0.6)	72.2
Total life contract liabilities	**12,845.3**	**12,870.2**	**12,323.7**

	Life investment contract liabilities		Life insurance contract liabilities		Outward reinsurance contract liabilities		Total life contract liabilities	
Movement in life contract liabilities	31 Dec 2019 $m	31 Dec 2018 $m	31 Dec 2019 $m	31 Dec 2018 $m	31 Dec 2019 $m	31 Dec 2018 $m	31 Dec 2019 $m	31 Dec 2018 $m
Balance at the beginning of the period	6,757.7	6,635.3	6,113.1	5,016.7	(0.6)	76.3	12,870.2	11,728.3
Deposits and premium receipts	1,275.8	1,524.3	692.8	625.8	-	-	1,968.6	2,150.1
Payments and withdrawals	(1,659.9)	(1,526.7)	(394.5)	(312.4)	-	(5.9)	(2,054.4)	(1,845.0)
Revenue per Note 1	(15.2)	(2.9)	(442.3)	(232.7)	(0.1)	0.7	(457.6)	(234.9)
Expense per Note 2	70.5	120.1	448.0	404.0	-	1.1	518.5	525.2
Balance at the end of the period	**6,428.9**	**6,750.1**	**6,417.1**	**5,501.4**	**(0.7)**	**72.2**	**12,845.3**	**12,323.7**

Accounting policy

The operations of the Group include the selling and administration of life contracts through Challenger Life Company Limited (CLC). These contracts are governed under the *Life Insurance Act 1995* (the Life Act) and are classified as either life insurance contracts or life investment contracts. Life insurance and life investment contract liabilities are collectively referred to as life contract liabilities or policy liabilities.

Life investment contract liabilities

Life investment contracts are contracts regulated under the Life Act which do not meet the definition of life insurance contracts under AASB 1038 *Life Insurance Contracts* and similar contracts issued by entities operating outside of Australia.

For fixed term policies the liability is based on the fair value of the income payments and associated expenses, being the net present value of the payments and expenses using an appropriate discount rate curve as determined by the Appointed Actuary.

Life insurance contract liabilities

Life insurance contracts are contracts regulated under the Life Act that involve the acceptance of significant insurance risk. Insurance risk is defined as significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance (i.e. have no discernible effect on the economics of the transaction).

The financial reporting methodology used to determine the value of life insurance contract liabilities is referred to as margin on services (MoS). Under MoS, the excess of premiums received over payments to customers and expenses (the margin) is recognised over the life of the contract in a manner that reflects the pattern of risk accepted from the policyholder (the service) unless future margins are negative, in which case the future losses are recognised in the statement of comprehensive income in the period in which they occur. The planned release of this margin is recognised in the statement of comprehensive income as part of the life insurance contract premiums and related revenue.

Life insurance contract liabilities are usually determined using a projection method, whereby estimates of policy cash flows (premiums, payments and expenses) are projected into the future. The liability is calculated as the net present value of these projected cash flows using a risk-free discount rate curve.

The key areas of judgement in the determination of the actuarial assumptions are the duration of claims/policy payments, acquisition and maintenance expense levels, and economic assumptions for discount and inflation rates.

Life insurance premium revenue

Life insurance premiums are recognised as revenue as earned.

Life insurance claims expense

Life insurance claims expense is recognised in expenses when the liability to the policyholder under the contract has been established.

Note 7 Life contract liabilities (continued)

Inwards reinsurance

During the period, the Group has maintained inwards reinsurance arrangements that meet the definition of a life insurance contract. The MoS methodology requires the present value of future cash flows arising from reinsurance contracts to be included in the calculation of life insurance contract liabilities.

Outwards reinsurance

The Group maintained outwards reinsurance arrangements to manage longevity risk in respect of part of the closed book of individual lifetime annuities.

Valuation

The MoS valuation, calculated in accordance with APRA Prudential Standards, results in the systematic release of planned margins over the life of the policy via a 'profit carrier'. The Group maintains life insurance contracts including individual lifetime annuities, wholesale mortality, wholesale morbidity and longevity reinsurance. Annuity payments are used as the profit carrier for individual lifetime annuities; premium receipts or best estimate claim payments are used as the profit carrier for wholesale mortality, wholesale morbidity and longevity reinsurance.

Key assumptions applied in the valuation of life contract liabilities

Tax rates

The bases of taxation (including deductibility of expenses) are assumed to continue in accordance with legislation current at the reporting date.

Discount rates

Under APRA Prudential Standards and AASB 1038 *Life Insurance Contracts*, life insurance contract liabilities are calculated by discounting expected future cash flows at a risk-free rate, set at the Commonwealth Government Bond curve plus an illiquidity premium where applicable or for foreign-denominated liabilities, a curve derived from the yields of highly liquid AAA-rated sovereign risk securities in the currency of the policy liabilities plus an illiquidity premium where applicable. The illiquidity premium is determined by reference to observable market rates including Australian sovereign debt, corporate, securitised and collateralised debt publicly placed in the domestic market, and market swap rates.

Life investment contract liabilities are calculated under the fair value through profit and loss provisions of AASB 9 *Financial Instruments*. The discount rates are determined based on the current observable, objective rates that relate to the nature, structure and term of the future liability cash flows.

For both insurance and investment contracts the approach is the same as adopted at 30 June 2019. Discount rates applied for Australian liabilities were between 1.4-2.6% (30 June 2019: 1.5-2.5%) per annum.

Expenses

Forecast expenses for the next year are allocated between acquisition, maintenance and investment based on the nature of the expense. Forecast maintenance expenses then are converted to a per-contract unit cost or percentage of account balance, depending on the nature of the expense.

Inflation

Inflation estimates are based on long-term expectations and reviewed at least annually for changes in the market environment based on a comparison of real and nominal yields of instruments of equivalent term and credit risk. The current assumption for Australia is 1.4% per annum for short-term inflation and 2.0% per annum for long-term (30 June 2019: 1.2% short-term, 1.6% long-term).

Surrenders

For life investment contracts, no surrenders or voluntary discontinuances are assumed. For Australian life insurance contracts where a surrender value is payable on withdrawal, a rate of surrenders is assumed in line with Challenger's own experience on these products, currently between 1.5%-2.1% per annum. For inwards reinsurance of Japanese business, a rate of surrenders is assumed in line with local experience in relation to similar contracts, currently 3.5% per annum (30 June 2019: 3.5%).

Where policyholders have the option to commute a life insurance contract, the value of this option is included within the life contract liabilities. We also assume surrender rates based on past experience for this business which vary by product types and duration in-force for the contract.

Mortality

Base mortality rates for individual lifetime annuities are determined as a multiple of annuitant experience based on LML08 and LFL08 tables, adjusted for Challenger's own recent experience. LML08 and LFL08 are mortality tables developed by the Continuous Mortality Investigation (CMI) based on United Kingdom annuitant lives experience from 2007–2010. The tables refer to male and female lives respectively. Rates are adjusted for expected future mortality improvements based on observed and expected improvements. For the age ranges and cash flow projection periods that contribute the majority of CLC's exposure, rates of future mortality improvement applied are between 0.3-2.6% per annum (30 June 2019: 0.3-2.6%).

Base mortality rates for wholesale mortality and longevity reinsurance are determined as a multiple of pensioner mortality rates (based on the self-administered pension schemes or SAPS2 tables mortality investigation developed by the Institute and Faculty of Actuaries (UK) using United Kingdom data collected between 2004–2012). Rates are adjusted for expected future mortality improvements based on observed and expected improvements. For the age ranges and cash flow projection periods that contribute the majority of CLC's exposure, rates of future mortality improvement applied are between 0.6%-2.1% per annum (30 June 2019: 0.6%-2.1%). Base mortality rates for the inwards reinsurance of Japanese business are determined as a multiple of Japanese population mortality rates.

Note 7 Life contract liabilities (continued)

Impact of changes in assumptions on life insurance contracts

Under MoS, changes in actuarial assumptions are recognised by adjusting the value of future profit margins in life insurance contract liabilities. Changes in future profit margins are released over future periods unless that product group is in an expected net loss position (loss recognition), in which case changes in assumptions are recognised in the statement of comprehensive income in the period in which they occur. The valuation impact of changes to discount rate assumptions as a result of market and economic conditions, such as changes in benchmark market yields, are recognised in the statement of comprehensive income in the period in which they occur.

Restrictions on assets

Financial assets held in Challenger Life Company Limited (CLC) can only be used within the restrictions imposed under the *Life Insurance Act 1995* (the Life Act). The main restrictions are that the assets in a statutory fund can only be used to meet the liabilities and expenses of that statutory fund, to acquire investments to further the business of the statutory fund or as distributions when capital adequacy requirements are met.

Statutory fund information

The life contract operations of CLC are conducted within four separate statutory funds as required by the Life Act. Both the shareholders' and policyholders' interests in these statutory funds are reported in aggregate in the financial report of the Group. Fund 1 is a non-investment-linked fund and Fund 3 is investment-linked. Both of these are closed to new business. Funds 2 and 4 are the principal operating funds of the Group. Fund 2 contains non-investment-linked contracts, including the Group's term annuity business, lifetime annuity policies and the related outwards reinsurance, plus the wholesale mortality, wholesale morbidity and longevity inwards reinsurance. Fund 4 contains inwards reinsurance of annuity business written in Japan.

Life contract liabilities for Funds 1, 2, 3 and 4 are $1.9 million, $11,304.9 million, $2.8 million and $1,535.7 million respectively (30 June 2019: are $2.0 million, $11,649.0 million, $2.9 million and $1,216.3 million).

Life insurance risk

The Group is exposed to longevity risk on its individual lifetime annuities (both direct and reinsured) and wholesale longevity reinsurance. Longevity risk is the risk that policyholders may live longer than expectations. The Group is exposed to mortality risk on the wholesale mortality reinsurance and reinsurance of fixed term business written in Japan. This is the risk that death rates in the reference portfolios exceed expectations. The Group is also exposed to morbidity risk on the wholesale morbidity reinsurance. That is the risk that morbidity rates in the reference portfolios exceed expectation. The Group manages the longevity risk with regular reviews of the portfolio to confirm continued survivorship of policyholders receiving income plus regular reviews of longevity experience to ensure that longevity assumptions remain appropriate. In addition, the Group has entered into reinsurance arrangements to manage longevity risk in respect of closed books of individual lifetime annuities. The Group manages the mortality and morbidity risk with regular reviews of the portfolio to ensure that mortality and morbidity assumptions remain appropriate. The Company's insurance risk policy is approved by the Board and sets out the relevant risk limits for insurance exposures, to ensure the insurance risk portfolio is appropriately diversified and contains no significant concentrations of insurance risk.

Actuarial information

Mr A Kapel FIAA, as the Appointed Actuary of CLC, is satisfied as to the accuracy of the data used in the valuations of life contract liabilities in the financial report and the tables in this note. The life contract liabilities have been determined at the reporting date in accordance with the Life Act, APRA Prudential Standards, AASB 1038 *Life Insurance Contracts*, and AASB 9 *Financial Instruments*.

Note 8 Notes to statement of cash flows

Reconciliation of profit to operating cash flow	31 Dec 2019 $m	31 Dec 2018 $m
Profit for the period	**222.2**	**6.2**
Adjusted for		
Net realised and unrealised gains and losses on investment assets	(58.6)	55.8
Share of associates' net profit	(12.8)	(11.7)
Change in life contract liabilities[1]	60.9	290.3
Depreciation and amortisation expense	7.8	7.5
Impairment/(reversal of impairment) in associates and other investments	8.9	(24.8)
Share-based payments	7.5	10.9
Dividends from associates	13.2	23.5
Change in operating assets and liabilities		
Decrease in receivables	44.9	53.4
Decrease/(increase) in other assets	6.8	(6.5)
Decrease in payables	(59.1)	(30.8)
(Decrease)/increase in provisions	(2.2)	1.5
(Decrease)/increase in life contract liabilities	(85.8)	305.1
Increase in external unit holders' liabilities	739.4	37.3
Increase/(decrease) in net tax liabilities	47.9	(63.2)
Net cash flows from operating activities	**941.0**	**654.5**

[1] Changes relate to movements through the statement of comprehensive income.

Reconciliation of cash	31 Dec 2019 $m	31 Dec 2018 $m
Cash at bank and on hand	760.2	475.6
Cash at bank and on hand – SPV	65.0	74.1
Total cash and cash equivalents[1]	**825.2**	**549.7**

[1] All cash and cash equivalents are considered current.

Note 9 Contributed equity

	6 months to 31 December 2019 No. of shares m	6 months to 31 December 2019 Value of shares $m	Year to 30 June 2019 No. of shares m	Year to 30 June 2019 Value of shares $m	6 months to 31 December 2018 No. of shares m	6 months to 31 December 2018 Value of shares $m
Analysis of contributed equity						
Ordinary shares issued and fully paid	612.0	2,157.9	611.6	2,155.3	611.2	2,151.9
CPP Trust shares treated as Treasury shares	(2.4)	(24.8)	(3.0)	(30.5)	(3.0)	(30.6)
CPP deferred share purchases treated as Treasury shares	(2.0)	(22.3)	(2.8)	(31.1)	(2.8)	(31.1)
Total contributed equity	**607.6**	**2,110.8**	**605.8**	**2,093.7**	**605.4**	**2,090.2**
Movements in contributed equity						
Ordinary shares						
Balance at the beginning of the period	611.6	2,155.3	610.9	2,148.5	610.9	2,148.5
Issued under dividend reinvestment plan	0.4	2.6	0.7	6.8	0.3	3.4
Balance at the end of the period	612.0	2,157.9	611.6	2,155.3	611.2	2,151.9
CPP Trust						
Balance at the beginning of the period	3.0	30.5	4.4	40.4	4.4	40.4
Shares purchased (including settled forwards)	0.8	8.8	2.8	32.8	2.8	32.8
Vested shares released to employees	(1.4)	(14.5)	(4.2)	(42.7)	(4.2)	(42.6)
Balance at the end of the period	2.4	24.8	3.0	30.5	3.0	30.6
CPP deferred share purchases						
Balance at the beginning of the period	2.8	31.1	4.8	56.4	4.8	56.4
CPP deferred share purchases	-	-	0.8	7.5	0.8	7.5
Settled forward purchases	(0.8)	(8.8)	(2.8)	(32.8)	(2.8)	(32.8)
Balance at the end of the period	2.0	22.3	2.8	31.1	2.8	31.1

Capital management

Dividend Reinvestment Plan (DRP)

The Company maintained a DRP for the 2019 final dividend. On 25 September 2019, the Company issued 364,482 ordinary shares to shareholders under the DRP. The DRP issue price per share for the 2019 final dividend was $7.0372 and represents the volume weighted average share price over the ten trading days from 4 to 17 September 2019. The DRP participation rate was 2.3% of all issued shares, resulting in proceeds of $2.6 million.

Internal Capital Adequacy Assessment Process (ICAAP) Summary Statement – CLC

CLC is a life insurance company regulated under the Life Act. The Life Act, via prudential standards issued by APRA, imposes minimum statutory capital requirements on all life insurance companies. Under these standards a life company must have in place an ICAAP, documented in an ICAAP Summary Statement. CLC complied with these requirements at all times during the period.

Prescribed Capital Amount (PCA)

CLC holds capital in order to ensure that under a range of adverse scenarios it can continue to meet its regulatory and contractual obligations to its customers. CLC is regulated by APRA and is required to hold a minimum level of regulatory capital.

CLC's regulatory capital base and PCA have been calculated in accordance with APRA's prudential capital standards.

While CLC does not target a specific PCA ratio, under current circumstances CLC's internal capital models result in a PCA ratio in the range of 1.3 to 1.6 times. This range can change over time and is dependent on numerous factors. CLC's PCA ratio is currently within this range of 1.3 to 1.6 times.

The PCA ratio at 31 December 2019 was 1.54 times (30 June 2019: 1.53 times), reflecting changes in asset allocation, net AUM growth and changes in retained earnings.

Note 9 Contributed equity (continued)

Capital management (continued)

CLC's target surplus

CLC maintains a target level of capital representing APRA's PCA plus a target surplus. The target surplus is a management guide to the level of excess capital that CLC seeks to hold over and above APRA's minimum requirements. CLC's target surplus is set to ensure that it provides a buffer against adverse market conditions and having regard to CLC's credit rating.

CLC uses internal capital models to determine its target surplus, which are risk-based and responsive to changes in CLC's asset allocation and market conditions.

Details of the CLC capital adequacy multiple can be seen below:

CLC capital	31 Dec 2019 $m	30 June 2019 $m	31 Dec 2018 $m
CLC's regulatory capital			
Common Equity Tier 1 regulatory capital	2,811.3	2,789.4	2,517.6
Additional Tier 1 regulatory capital	805.0	805.0	805.0
Tier 2 regulatory capital – subordinated debt[1]	406.2	405.3	402.2
CLC total regulatory capital base	**4,022.5**	**3,999.7**	**3,724.8**
Prescribed capital amount			
Asset risk charge[2]	2,523.6	2,539.5	2,355.2
Insurance risk charge[3]	164.6	135.3	83.3
Operational risk charge	53.4	51.8	47.5
Aggregation benefit	(125.4)	(104.0)	(64.8)
CLC prescribed capital amount	**2,616.2**	**2,622.6**	**2,421.2**
CLC excess over prescribed capital amount	**1,406.3**	**1,377.1**	**1,303.6**
Capital adequacy ratio (times)	**1.54**	**1.53**	**1.54**

[1] Differs from $404.9 million (30 June 2019: $403.8 million) disclosed in Note 10 Interest bearing financial liabilities due to $1.1 million (30 June 2019: $1.5 million) of accrued interest.
[2] Asset risk charge includes the combined stress scenario adjustment and default stress.
[3] During the period, CLC entered into three new UK longevity swaps transactions resulting in an increase in insurance risk charge and aggregation benefit at 31 December 2019 compared to 30 June 2019.

Note 10 Interest bearing financial liabilities

	30 June 2019 Facility $m	30 June 2019 Opening balance $m	Cash flows Proceeds/ (repayments) $m	Non-cash movements Foreign Exchange $m	Non-cash movements Fair value changes $m	Non-cash movements Other $m	31 Dec 2019 Closing balance $m	31 Dec 2019 Facility $m
Bank loans								
Corporate	400.0	-	-	-	-	-	-	400.0
Controlled property trusts[1]	459.8	459.8	(8.6)	(4.3)	1.1	1.4	449.4	449.4
Controlled infrastructure trusts	192.0	192.0	(3.0)	-	-	-	189.0	189.0
Repurchase agreements	4,448.5	4,448.5	11.5	-	-	-	4,460.0	4,460.0
Total bank loans	5,500.3	5,100.3	(0.1)	(4.3)	1.1	1.4	5,098.4	5,498.4
Non-bank loans								
Subordinated debt	400.0	403.8	-	-	1.1	-	404.9	400.0
Challenger Capital Notes 1	345.0	343.6	-	-	-	0.9	344.5	345.0
Challenger Capital Notes 2	460.0	452.7	-	-	-	0.9	453.6	460.0
Other finance	12.7	12.7	(12.2)	-	(0.5)	-	-	-
Total non-bank loans	1,217.7	1,212.8	(12.2)	-	0.6	1.8	1,203.0	1,205.0
Total interest bearing financial liabilities	6,718.0	6,313.1	(12.3)[2]	(4.3)	1.7	3.2	6,301.4	6,718.6
Current		4,473.2					4,483.3	
Non-current		1,839.9					1,818.1	
		6,313.1					6,301.4	

[1] Total facility limit consists of redraw loan facility limits totalling nil (30 June 2019: nil) and non-redraw loan facility limits totalling $449.4 million (30 June 2019: $459.8 million)

[2] Differs to Statement of cash flows due to $77.0 million (30 June 2019: $189.0 million) repayments relating to SPVs. Total cash proceeds comprise $11.5 million (30 June 2019: $632.8 million) proceeds from borrowings and $100.8 million (30 June 2019: $315.4 million) repayments of borrowings, inclusive of SPVs.

Repurchase agreements

CLC has entered into repurchase agreements with certain counterparties whereby fixed income securities are sold for cash whilst simultaneously agreeing to repurchase the fixed income security at a fixed price on a fixed date in the future. These agreements finance bonds held for hedging purposes and are interest bearing, with interest included in the price at which the bonds are repurchased and paid on repurchase. All agreements as at 31 December 2019 are current with maturity dates in January 2020 and February 2020. They will continue to be rolled into new agreements in the future.

CLC uses Australian Government and Semi-Government Bonds with repurchase agreements, interest rate swaps and bond futures to hedge movements in interest rates on its asset portfolio, annuity policy liabilities, Guaranteed Index Return mandates and the Challenger Index Plus Fund.

Note 11 Dividends paid and proposed

	31 Dec 2019 $m	31 Dec 2018 $m
Dividends declared and paid during the year		
Final 30 June 2019 100% franked dividend: 18.0 cents (30 June 2018: 18.0 cents 100% franked dividend)	109.7	109.4
Dividend proposed (not recognised as a liability at 31 December)		
2020 interim 100% franked dividend: 17.5 cents (2019 interim: 17.5 cents 100% franked)	106.7	106.4

A dividend reinvestment plan will be in operation for the 2020 interim dividend.

Dividend franking credits

Franking credits available to shareholders are $117.2 million (30 June 2019: $87.5 million), based on a tax rate of 30%. This amount is calculated from the balance of the franking account as at the end of the reporting period, adjusted for franking credits that will arise from the settlement, after the end of the reporting period, of current liabilities for income tax and interest on Challenger Capital Notes 1 and 2.

The impact of the proposed dividend will be to reduce the balance of the franking account by $45.7 million. All dividends are franked at a tax rate of 30%.

Note 12 Earnings per share

	31 Dec 2019 cents	31 Dec 2018 cents
Basic earnings per share	36.3	1.0
Diluted earnings per share	31.5	1.0
	$m	**$m**
Profit attributable to ordinary shareholders	220.4	6.1
Add back interest expense on Challenger Capital Notes 1 and 2	14.4	-
Add back interest expense net of tax on CLC Subordinated Notes	4.5	-
Total earnings used in the calculation of diluted earnings per share	**239.3**	**6.1**
Number of shares	**Number**	**Number**
Weighted average of ordinary shares issued	611,800,663	611,029,546
Weighted average of Treasury shares	(4,721,804)	(6,654,339)
Weighted average ordinary shares for basic earnings per share	**607,078,859**	**604,375,207**
Adjusted for potential ordinary shares:		
Weighted average effect of Challenger Performance Plan	4,280,874	7,140,117
Weighted average effect of Challenger Capital Notes 1 and 2	99,526,477	-
Weighted average effect of CLC Subordinated Notes	49,454,150	-
Weighted average ordinary shares for diluted earnings per share	**760,340,360**	**611,515,324**

Accounting policy

Basic earnings per share is calculated by dividing the total profit for the year attributable to equity holders of the Company by the weighted average number of ordinary shares outstanding during the financial year. The number of ordinary shares outstanding is net of Treasury shares held by the Challenger Performance Plan (CPP) Trust or under CPP deferred share purchase agreements in respect of equity incentive plan awards to employees.

The weighted average number of Treasury shares for the period was 4,721,804 (31 December 2018: 6,654,339).

Accounting treatment of Capital Notes and subordinated debt

Challenger Capital Notes 1 and 2 and subordinated debt are an effective source of funding for Challenger.

Each of the Capital Notes 1 and 2 and subordinated debt have convertibility features which would result in these instruments converting to ordinary shares under certain circumstances, including APRA determining Challenger Life to be non-viable. It is Challenger's current intention to refinance each of these instruments at their respective call dates and therefore conversion to ordinary shares is unlikely.

However, under AASB 133 *Earnings per Share*, convertible debt is considered dilutive whenever the interest per potential ordinary share for each of these instruments is less than Challenger's basic EPS for the period. As such, a test is required at each reporting period to determine if they are included in the dilutive share count.

Diluted earnings per share is calculated by dividing the total adjusted profit attributable to equity holders of the Company by the weighted average number of ordinary shares outstanding during the period adjusted for the effects of dilutive shares that may be converted under the terms of Challenger Capital Notes 1 and 2 (Notes) of 99.5 million shares (31 December 2018: nil), CLC Subordinated Notes of 49.5 million shares (31 December 2018: nil) and shares granted under the CPP of 4.3 million shares (31 December 2018: 7.1 million).

The dilutive share count for Challenger's convertible debt (Challenger Capital Notes 1 and 2 and CLC Subordinated Notes) is based on the following formula:

$$\frac{\text{Face value of debt}}{\text{Conversion factor x Challenger's 20-day VWAP share price}}$$

The conversion factor on all Challenger's convertible debt is 99% of the weighted average Challenger share price over the last 20 days of trading in each reporting period.

The profit attributable to ordinary shareholders is adjusted by $18.9 million in interest on the Notes and CLC Subordinated Notes (31 December 2018: nil) for the diluted calculation when the Notes and CLC Subordinated Notes are considered dilutive. Since the CPP Trust commenced operation in December 2006, no shares have been issued to the CPP Trust. Instead, shares are acquired by the CPP Trust to mitigate shareholder dilution.

There have been no other transactions involving ordinary shares or potential ordinary shares between the reporting date and the date of authorisation of these financial statements.

Note 13 Fair values of financial assets and liabilities

Fair value determination and classification

Fair value reflects the price that would be received on sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The majority of the Group's financial instruments are held in the life insurance statutory funds of CLC and, as a result, are required by AASB 1038 *Life Insurance Contracts* to be designated at fair value through profit and loss where this is permitted under AASB 9 *Financial Instruments*.

Financial instruments measured at fair value are categorised under a three-level hierarchy, reflecting the availability of observable market inputs when estimating the fair value. If different levels of inputs are used to measure a financial instrument's fair value, the classification within the hierarchy is based on the lowest level that is significant to the fair value measurement. The three levels are:

Level 1	Unadjusted quoted prices in active markets are the valuation inputs for identical assets or liabilities (i.e. listed securities).
Level 2	Valuation inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (as prices) or indirectly (derived from prices) are used.
Level 3	There are valuation inputs for the asset or liability that are not based on observable market data (unobservable inputs).

The unobservable inputs into the valuation of the Group's Level 3 assets and liabilities are determined based on the best information available, including the Group's own assessment of the assumptions that market participants would use in pricing the asset or liability. Examples of unobservable inputs are estimates about the timing of cash flows, discount rates, earnings multiples and internal credit ratings.

Valuation techniques

The majority of the Group's listed and unlisted fixed income securities, over-the-counter derivative financial instruments and interest bearing liabilities including the subordinated debt issuance are classified as Level 2. This recognises the availability of a quoted price, but not from an active market as defined by the standard. Fixed income securities where market observable inputs are not available are classified as Level 3.

The Group's derivative financial instruments are traded over-the-counter so, whilst they are not exchange traded, there is a market observable price. All of the fixed income and government/semi-government securities have prices determined by a market.

Externally-rated unlisted fixed income securities are valued by applying market observable credit spreads on similar assets with an equivalent credit rating. Internally-rated fixed income securities are Level 3, as the determination of an equivalent credit rating is a significant non-observable input.

Equity, infrastructure and property securities that are exchange traded are generally classified Level 1. Where quoted prices are available, but are not from an active market, they are classified Level 2. If market observable inputs are not available, they are classified Level 3. Valuations can make use of cash flow forecasts discounted using the applicable yield curve, earnings-multiple valuations or, for managed funds, the net assets of the trust per the most recent financial report.

External unit holders' liabilities are valued at the face value of the amounts payable and classified as Level 2. The portion of life investment contract liabilities classified as Level 2 represent products or product options for which the liability is determined based on an account balance, rather than a discounted cash flow as applied to the rest of the portfolio.

Cash and cash equivalents are carried at amortised cost. To determine a fair value where the asset is liquid or maturing within three months, the fair value is approximate to the carrying amounts. This assumption is applied to liquid assets and the short-term elements of all other financial assets and financial liabilities.

The mortgage SPVs have total equity attributable to residual income unitholders (RIU) at amortised cost of $0.1 million (30 June 2019: $0.2 million). The fair value of this RIU asset is $44.8 million (30 June 2019: $62.4 million) and would be classified as Level 3 in the fair value hierarchy.

Challenger Capital Notes 1 and 2 have carrying values of $345.0 million and $460.0 million. The fair value of these notes is $347.9 million and $485.3 million respectively and they are classified as Level 1 in the fair value hierarchy.

Valuation process

For financial instruments and investment properties categorised within Level 3 of the fair value hierarchy, the valuation process applied in valuing such instruments is governed by the CLC Practice Note on Investment Asset and Financial Liability Valuation. The Practice Note outlines the Valuation Committee's responsibilities in the valuation of investment assets and financial liabilities for the purposes of financial reporting. All significant Level 3 financial instruments are referred to the Valuation Committee which generally meets monthly, or more frequently if required.

All financial instruments and investment properties are measured on a recurring basis. The table on the following page summarises the financial instruments and investment properties measured at fair value at each level of the fair value hierarchy as at the statement of financial position date.

Note 13 Fair values of financial assets and liabilities (continued)

Valuation process (continued)

	Level 1 $m	Level 2 $m	Level 3 $m	Total $m
31 Dec 2019				
Derivative assets	-	819.3	0.6	819.9
Fixed income securities[1]	-	16,331.6	2,073.6	18,405.2
Equity and other alternatives	0.8	1,218.9	249.3	1,469.0
Infrastructure investments[1]	209.6	260.1	370.3	840.0
Property securities	-	-	99.7	99.7
Investment and development property	-	-	3,703.6	3,703.6
Total assets	**210.4**	**18,629.9**	**6,497.1**	**25,337.4**
Derivative liabilities	-	468.1	-	468.1
Interest bearing financial liabilities	833.2	438.6	-	1,271.8
External unit holders' liabilities	-	2,705.6	-	2,705.6
Life investment contract liabilities	-	55.6	6,373.3	6,428.9
Total liabilities	**833.2**	**3,667.9**	**6,373.3**	**10,874.4**
30 June 2019				
Derivative assets	-	761.9	0.6	762.5
Fixed income securities[1]	-	15,604.8	1,997.7	17,602.5
Equity and other alternatives	6.9	1,025.7	299.6	1,332.2
Infrastructure investments[1]	210.6	234.9	421.6	867.1
Property securities	-	-	127.8	127.8
Investment and development property	-	155.8	3,573.4	3,729.2
Total assets	**217.5**	**17,783.1**	**6,420.7**	**24,421.3**
Derivative liabilities	-	569.1	0.1	569.2
Interest bearing financial liabilities	836.0	443.1	12.5	1,291.6
External unit holders' liabilities	-	1,966.2	-	1,966.2
Life investment contract liabilities	-	58.1	6,699.6	6,757.7
Total liabilities	**836.0**	**3,036.5**	**6,712.2**	**10,584.7**
31 Dec 2018				
Derivative assets	-	428.7	0.6	429.3
Fixed income securities[1]	-	14,534.5	2,004.7	16,539.2
Equity and other alternatives	7.2	991.3	343.9	1,342.4
Infrastructure investments[1]	176.5	197.3	398.7	772.5
Property securities	-	-	132.7	132.7
Investment and development property	-	279.6	3,811.6	4,091.2
Total assets	**183.7**	**16,431.4**	**6,692.2**	**23,307.3**
Derivative liabilities	0.7	532.7	0.1	533.5
Interest bearing financial liabilities	841.6	445.6	13.6	1,300.8
External unit holders' liabilities	-	2,172.3	-	2,172.3
Life investment contract liabilities	-	60.0	6,690.1	6,750.1
Total liabilities	**842.3**	**3,210.6**	**6,703.8**	**10,756.7**

[1] The Group has exposures to structured entities (entities designed so that voting or similar rights are not the dominant factor in determining who controls the entity; for example, when any voting rights relate purely to administrative tasks) via investments in asset-backed finance vehicles (where it may act as a lender or purchaser of notes and/or residual income units) and securitisations (such as mortgages, finance leases and other types of collateralised vehicles). The Company assesses, at inception and at each reporting date, whether a structured entity should be consolidated based on the accounting policy. The maximum exposure to loss is limited to the reported fair value of the underlying securities plus any guaranteed undrawn commitments to the counterparties. At 31 December 2019 the carrying value of asset-backed financing assets was $95.9 million (30 June 2019: $81.8 million) with $4.5 million in undrawn commitments (30 June 2019: $39.5 million) and the carrying value of securitisations was $5,276.2 million (30 June 2019: $4,313.3 million) plus $98.2 million in undrawn commitments (30 June 2019: $81.2 million).

Note 13 Fair values of financial assets and liabilities (continued)

Level 3 sensitivities

The following table shows the sensitivity of Level 3 financial instruments to a reasonable change in alternative assumptions in respect of the non-observable inputs into the fair value calculation:

	Level 3 value[1] $m	Positive impact $m	Negative impact $m	Valuation technique	Reasonable change in non-observable input[2,3]
31 Dec 2019					
Derivative assets	0.6	-	-	Discounted cash flow	Primarily credit spreads
Derivative liabilities	-	-	-	Discounted cash flow	Primarily credit spreads
Fixed income securities	2,073.6	8.5	(78.3)	Discounted cash flow	Primarily credit spreads
Interest bearing financial liabilities	-	-	-	Discounted cash flow	Primarily credit spreads
Equity and other alternatives	249.3	18.8	(20.2)	Pricing model	Earnings multiple, Mortality rate
Infrastructure investments	370.3	2.7	(2.7)	Discounted cash flow, External financial report	Primarily discount rate on cash flow models
Property securities	99.7	5.0	(5.0)	Market capitalisation, Discounted cash flow	Primarily capitalisation rate
Investment contract liabilities	(6,373.3)	3.2	(3.2)	Discounted cash flow	Primarily expense assumptions
Investment and development property	3,703.6	183.7	(152.5)	Market capitalisation, Discounted cash flow	Primarily capitalisation rate
Total Level 3	**123.8**	**221.9**	**(261.9)**		
30 June 2019					
Derivative assets	0.6	0.1	(0.1)	Discounted cash flow	Primarily credit spreads
Derivative liabilities	(0.1)	0.2	0.1	Discounted cash flow	Primarily credit spreads
Fixed income securities	1,997.7	10.5	(37.2)	Discounted cash flow	Primarily credit spreads
Interest bearing financial liabilities	(12.5)	0.2	(0.4)	Discounted cash flow	Primarily credit spreads
Equity and other alternatives	299.6	22.7	(24.2)	Pricing model	Earnings multiple, Mortality rate
Infrastructure investments	421.6	4.9	(4.9)	Discounted cash flow, External financial report	Primarily discount rate on cash flow models
Property securities	127.8	6.4	(6.4)	Market capitalisation, Discounted cash flow	Primarily capitalisation rate
Investment contract liabilities	(6,699.6)	3.5	(3.5)	Discounted cash flow	Primarily expense assumptions
Investment and development property	3,573.4	166.7	(152.7)	Market capitalisation, Discounted cash flow	Primarily capitalisation rate
Total Level 3	**(291.5)**	**215.2**	**(229.3)**		
31 Dec 2018					
Derivative assets	0.6	0.1	(0.1)	Discounted cash flow	Primarily credit spreads
Derivative liabilities	(0.1)	0.3	(0.2)	Discounted cash flow	Primarily credit spreads
Fixed income securities	2,004.7	10.9	(48.3)	Discounted cash flow	Primarily credit spreads
Interest bearing financial liabilities	(13.6)	0.1	(0.1)	Discounted cash flow	Primarily credit spreads
Equity and other alternatives	343.9	24.6	(26.2)	Pricing model	Earnings multiple, Mortality rate
Infrastructure investments	398.7	6.4	(6.3)	Discounted cash flow, External financial report	Primarily discount rate on cash flow models
Property securities	132.7	6.6	(6.6)	Market capitalisation, Discounted cash flow	Primarily capitalisation rate
Investment contract liabilities	(6,690.1)	3.5	(3.5)	Discounted cash flow	Primarily expense assumptions
Investment and development property	3,811.6	173.3	(161.9)	Market capitalisation, Discounted cash flow	Primarily capitalisation rate
Total Level 3	**(11.6)**	**225.8**	**(253.2)**		

[1] The fair value of the asset or liability would increase/decrease if the credit spread discount rate or expense assumptions decrease/increase or if the other inputs increase/decrease.
[2] Specific asset valuations will vary from asset to asset as each individual industry profile will determine appropriate valuation inputs to be utilised.
[3] The effect of a change to reflect a reasonable possible alternative assumption was calculated by adjusting the credit spreads by a +/- one tier movement in internal credit rating bands, discount rates by between 50bps – 100bps, changing the valuation of the unlisted schemes by 5% and adjusting the expense assumption splits by 10%.

Note 13 Fair values of financial assets and liabilities (continued)

Level 3 reconciliation

The following table shows a reconciliation of the movement in the fair value of financial instruments categorised within Level 3 of the fair value hierarchy during the period:

	31 Dec 2019		30 June 2019		31 Dec 2018	
	Assets $m	Liabilities $m	Assets $m	Liabilities $m	Assets $m	Liabilities $m
Balance at the beginning of the period	6,420.7	6,712.2	6,440.9	6,585.3	6,398.3	6,585.3
Transfers to other categories[1, 2]	(14.7)	-	(43.6)	-	(65.8)	-
Fair value gains/(losses)	(16.4)	55.2	72.4	312.0	85.9	117.0
Acquisitions	1,543.6	1,251.4	2,723.3	2,354.0	1,450.2	1,483.6
Maturities and disposals	(1,436.1)	(1,645.5)	(2,772.3)	(2,539.1)	(1,176.4)	(1,482.1)
Balance at the end of the period	**6,497.1**	**6,373.3**	**6,420.7**	**6,712.2**	**6,692.2**	**6,703.8**
Unrealised gains/(losses) included in the statement of comprehensive income for assets and liabilities held at the statement of financial position date	(40.7)	(55.7)	76.3	(312.0)	62.4	(117.3)

[1] The Group transfers between levels of the fair value hierarchy when there is a change in the observability of the pricing inputs or a change to valuation methodology.
[2] Transfers to/from other categories are due to changes in the market observability of inputs used in the valuation of financial instruments. There were no transfers between Level 1 and Level 2 during the reporting period. There were no transfers into Level 3 (30 June 2019: $216.0 million) and there were $14.7 million of transfers out of Level 3 and into Level 2 (30 June 2019: $259.6 million) during the reporting period.

Note 14 Collateral arrangements

Accounting policy

CLC receives collateral, where it is considered necessary, when entering into certain financial arrangements. The amount of collateral required is subject to management's credit evaluation of the counterparty which is performed on a case-by-case basis. At 31 December 2019, $442.5 million (30 June 2019: $415.1 million) of cash received from third parties as collateral is recorded in payables. CLC is not permitted to sell or re-pledge financial or non-financial assets held as collateral in the absence of default by the owner of the collateral.

CLC is required to pledge collateral, as part of the standard terms of transactions, when entering into certain financial arrangements. Cash paid to third parties as collateral is recorded in receivables. Other financial assets transferred as collateral are not derecognised from the statements of financial position as the risks and rewards of ownership remain with CLC. At the balance sheet date the fair value of cash and financial assets pledged are as follows:

Collateral pledged as security	31 Dec 2019 $m	30 June 2019 $m
Cash	139.0	220.1
Other financial assets[1]	6,554.1	5,991.0
Total collateral pledged	**6,693.1**	6,211.1

[1] Includes assets sold under repurchase agreements. Please refer Note 10 Interest bearing financial liabilities for more information.

Note 15 Acquisitions and disposals of subsidiaries, businesses and associates

On 27 November 2019, 255 Finance (a member of the Company's Life business unit), agreed to acquire the residual equity of Assetsecure Pty Ltd (Assetsecure), a specialist trade receivables financier with approximately 10 employees. The Company had previously held a 35% equity interest disclosed as an investment in associates measured at fair value through profit or loss. As part of the business combination, the Company has consolidated 5 Special Purpose Vehicle (SPV) trusts that Assetsecure manages as it is both a significant noteholder and retains the beneficial interest in these SPVs.

A full acquisition of Assetsecure provides 255 Finance an extended accounts receivable origination and servicing capability, cost and revenue synergies and ongoing access to a key origination channel. From the date of acquisition, Assetsecure's revenue and expenses have been included in the statement of comprehensive income. Acquisition related transaction costs have been incurred through other expenses.

Details of the fair values of the assets and liabilities acquired and goodwill on acquisition are as follows:

	31 Dec 2019 $m
Total purchase consideration[1]	30.8
Less: fair value of net identifiable assets acquired	(7.8)
Provisional goodwill on acquisition[2]	**23.0**

[1] Includes existing investment; $20.0 million was paid to acquire the residual 65% interest.
[2] The measurement of net assets acquired may be subsequently adjusted with a corresponding adjustment to goodwill prior to 30 June 2020 in accordance with AASB 3 *Business Combinations*.

The balance sheet of Assetsecure and its SPVs at acquisition date was as follows:

	Acquiree's carrying amount $m	Fair value $m
Assets		
Cash and cash equivalents	9.8	9.8
Financial assets – fair value through profit and loss	316.8	316.8
Right-of-use lease asset	-	0.8
Receivables	0.7	0.7
Other assets	0.1	0.1
Other intangible assets	0.5	1.7
Total assets	**327.9**	**329.9**
Liabilities		
Payables	(177.0)	(177.0)
Provisions	(0.4)	(0.4)
Current tax liabilities	(0.1)	(0.1)
Deferred tax liabilities	0.1	(0.1)
Lease liabilities	-	(0.8)
Interest bearing financial liabilities	(143.7)	(143.7)
Total liabilities	**(321.1)**	**(322.1)**
Net assets	**6.8**	**7.8**

Other significant entities and businesses acquired or consolidated due to acquisition of control

There were no other significant entities or businesses acquired or consolidated due to acquisition of control during the period.

Significant entities and buisinesses disposed of or deconsolidated due to loss of control

There were no significant entities or businesses disposed of or deconsolidated due to loss of control during the period.

Note 16 Contingent liabilities, contingent assets and other commitments

Warranties

Over the course of its corporate activity the Group has given, as a seller of companies and as a vendor of assets, including real estate properties, warranties to purchasers on several agreements that are still outstanding at 31 December 2019. Other than noted below, at the date of this report no material claims against these warranties have been received by the Group.

Parent entity guarantees and undertakings

The Company has extended the following guarantees and undertakings to entities in the Group:

1. A guarantee supporting the corporate banking facility and certain other financial commitments, such as hedging arrangements;
2. Letters of support in respect of certain subsidiaries in the normal course of business. The letters recognise the Company's intention to provide support to those subsidiaries so that they can continue to meet their obligations;
3. Australian Financial Services Licence deeds of undertaking as an eligible provider; and
4. Guarantees to support contractual commitments on warranties to certain third parties.

Third-party guarantees

Bank guarantees have been issued by a third party financial institution on behalf of the Group and its subsidiaries for items in the normal course of business, such as rental contracts. The amounts involved are not considered to be material to the Group.

Contingent future commitments

CLC has made capital commitments to external counterparties for future investment opportunities such as development or investment purchases. At 31 December 2019 there were potential future commitments totalling $390.3 million (30 June 2019: $398.0 million) in relation to these opportunities. The Group has made capital commitments to associates to subscribe for up to $7.7 million (30 June 2019: $10.0 million) of non-redeemable preference shares to enable them to meet their working capital requirements. Contractual obligations for future property repairs and maintenance are in place but cannot be quantified until required.

Subsidiary guarantees

CLC has provided a guarantee to a third party regarding the performance of its subsidiary in respect of certain reinsurance arrangements.

Contingent tax assets and liabilities

From time-to-time the Group has interactions and matters under review or audit with the Australian Taxation Office in relation to the taxation treatments of various matters. Any potential tax liability resulting from these interactions is only provided for when it is probable that an outflow will occur and a reliable estimate of the amount can be made. No specific contingent liability amounts have been disclosed in relation to these matters as it would be prejudicial to the conduct and outcome.

Other information

In the normal course of business, the Group enters into various contracts that could give rise to contingent liabilities in relation to performance obligations under those contracts. The information usually required by Australian Accounting Standards is not disclosed for a number of such contracts on the grounds that it may seriously prejudice the outcome of the claims. At the date of this report, significant uncertainty exists regarding any potential liability under these claims.

Note 17 Subsequent events

At the date of this financial report no matter or circumstance has arisen that has affected, or may significantly affect, the Group's operations, the results of those operations, or the Group's state of affairs in future financial years which has not already been reflected in this report.

Directors' declaration

In accordance with a resolution of the Directors of Challenger Limited, we declare that, in the opinion of the Directors:

a) the financial statements and notes of Challenger Limited and its controlled entities (the Group) are in accordance with the *Corporations Act 2001*, including:

   (i) giving a true and fair view of the Group's financial position as at 31 December 2019 and of its performance for the six month period ended on that date; and

   (ii) complying with Australian Accounting Standard AASB 134 *Interim Financial Reporting* and the *Corporations Regulations 2001*; and

b) there are reasonable grounds to believe that the Group will be able to pay its debts as and when they become due and payable.

On behalf of the Board

P Polson
Independent Chair

Sydney
10 February 2020

R Howes
Managing Director and Chief Executive Officer

Sydney
10 February 2020

Building a better working world

Independent auditor's review report to the members of Challenger Limited

Report on the Half-Year Financial Report

Conclusion

We have reviewed the accompanying half-year financial report of Challenger Limited (the Company) and its subsidiaries (collectively the Group), which comprises the statement of financial position as at 31 December 2019, the statement of comprehensive income, statement of changes in equity and statement of cash flows for the half-year ended on that date, notes comprising a summary of significant accounting policies and other explanatory information, and the directors' declaration.

Based on our review, which is not an audit, nothing has come to our attention that causes us to believe that the half-year financial report of the Group is not in accordance with the *Corporations Act 2001*, including:

a) giving a true and fair view of the consolidated financial position of the Group as at 31 December 2019 and of its consolidated financial performance for the half-year ended on that date; and

b) complying with Accounting Standard AASB 134 *Interim Financial Reporting* and the *Corporations Regulations 2001*.

Directors' Responsibility for the Half-Year Financial Report

The directors of the Company are responsible for the preparation of the half-year financial report that gives a true and fair view in accordance with Australian Accounting Standards and the *Corporations Act 2001* and for such internal control as the directors determine is necessary to enable the preparation of the half-year financial report that is free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express a conclusion on the half-year financial report based on our review. We conducted our review in accordance with Auditing Standard on Review Engagements ASRE 2410 *Review of a Financial Report Performed by the Independent Auditor of the Entity* ("ASRE 2410"), in order to state whether, on the basis of the procedures described, anything has come to our attention that causes us to believe that the half-year financial report is not in accordance with the *Corporations Act 2001* including: giving a true and fair view of the Group's consolidated financial position as at 31 December 2019 and its consolidated financial performance for the half-year ended on that date; and complying with Accounting Standard AASB 134 *Interim Financial Reporting* and the *Corporations Regulations 2001*. As the auditor of the Group, ASRE 2410 requires that we comply with the ethical requirements relevant to the audit of the annual financial report.

A review of a half-year financial report consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Australian Auditing Standards and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Independence

In conducting our review, we have complied with the independence requirements of the *Corporations Act 2001*.

Ernst & Young

T Johnson
Partner

Sydney
10 February 2020

L Burns
Partner

Sydney
10 February 2020

Additional information

Principal place of business and registered office in Australia

Level 2
5 Martin Place
Sydney NSW 2000

Telephone: 02 9994 7000
Facsimile: 02 9994 7777

Investor services: 13 35 66

Directors

Peter Polson (Chair)
Richard Howes (Managing Director and Chief Executive Officer)
John M Green
Steven Gregg
Masahiko Kobayashi
JoAnne Stephenson
Duncan West
Melanie Willis

Company secretaries

Michael Vardanega
Andrew Brown

Website

› challenger.com.au

Manage your shareholding at Computershare Investor Services

Computershare Investor Services Pty Limited

Level 3, 60 Carrington Street

Sydney NSW 2000

Telephone: 02 8234 5000

› computershare.com.au

Telephone: 1800 780 782

Auditor

Ernst & Young
200 George Street
Sydney NSW 2000

Go electronic

Challenger can deliver all of your shareholder communications electronically, just update your details via Computershare Investor Services.

Online digital version of this report

The 2020 Interim Financial Report is available at:

› challenger.com.au/shareholder

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